

ECHELON CORP  
Form 10-Q  
May 06, 2010  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

(Mark one)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended March 31, 2010**

**OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the transition period from                      to**

**000-29748**

**(Commission file number)**

**ECHELON CORPORATION**

Edgar Filing: ECHELON CORP - Form 10-Q

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**77-0203595**  
(IRS Employer

Identification Number)

**550 Meridian Avenue**

**San Jose, CA 95126**

(Address of principal executive office and zip code)

**(408) 938-5200**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☒

Non-accelerated filer ☐ (do not check if a smaller reporting company) Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of April 30, 2010, 41,282,914 shares of the registrant's common stock were outstanding.

**Table of Contents****ECHELON CORPORATION****FORM 10-Q****FOR THE QUARTER ENDED MARCH 31, 2010****INDEX**

	<b>Page</b>
<b>Part I. <u>FINANCIAL INFORMATION</u></b>	
Item 1. <u>Unaudited Condensed Consolidated Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets as of March 31, 2010 and December 31, 2009</u>	3
<u>Condensed Consolidated Statements of Operations for the three months ended March 31, 2010 and 2009</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2010 and 2009</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	45
Item 4. <u>Controls and Procedures</u>	45
<b>Part II. <u>OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	47
Item 1A. <u>Risk Factors</u>	47
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	47
Item 6. <u>Exhibits</u>	48
<b><u>SIGNATURE</u></b>	48
<b><u>EXHIBIT INDEX</u></b>	49

**FORWARD-LOOKING INFORMATION**

*This report contains forward-looking statements within the meaning of the U.S. federal securities laws that involve risks and uncertainties. Certain statements contained in this report are not purely historical including, without limitation, statements regarding our expectations, beliefs, intentions, anticipations, commitments or strategies regarding the future that are forward-looking. These statements include those discussed in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, including Critical Accounting Estimates, Results of Operations, Off-Balance-Sheet Arrangements and Other Critical Contractual Obligations, Liquidity and Capital Resources, and Recently Issued Accounting Standards, and elsewhere in this report.*

*In this report, the words may, could, would, might, will, should, plan, forecast, anticipate, believe, expect, intend, estimate, predict, potential, continue, future, moving toward or the negative of these terms or other similar expressions also identify forward-looking statements. Our actual results could differ materially from those forward-looking statements contained in this report as a result of a number of risk factors including, but not limited to, those set forth in the section entitled Factors That May Affect Future Results of Operations and elsewhere in this report. You should carefully consider these risks, in addition to the other information in this report and in our other filings with the SEC. All forward-looking statements and reasons why results may differ included in this report are made as of the date of this report, and we assume no obligation to update any such forward-looking statement or reason why such results might differ.*

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
ECHELON CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands)****(Unaudited)**

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 8,660	\$ 17,206
Short-term investments	67,915	62,910
Accounts receivable, net <sup>(1)</sup>	13,665	21,496
Inventories	14,551	10,949
Deferred cost of goods sold	2,412	3,154
Other current assets	3,500	3,622
Total current assets	110,703	119,337
Property and equipment, net	34,427	35,595
Goodwill	8,342	8,496
Other long-term assets	989	1,009
Total assets	\$ 154,461	\$ 164,437
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 5,946	\$ 7,255
Accrued liabilities	7,088	4,850
Current portion of lease financing obligations	1,623	1,588
Deferred revenues	7,398	9,287
Total current liabilities	22,055	22,980
<b>LONG-TERM LIABILITIES:</b>		
Lease financing obligations, excluding current portion	23,376	23,794
Other long-term liabilities	1,548	1,765
Total long-term liabilities	24,924	25,559
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock	444	442
Additional paid-in capital	331,357	328,643
Treasury stock	(28,130)	(28,130)
Accumulated other comprehensive income	475	1,046

# Edgar Filing: ECHELON CORP - Form 10-Q

Accumulated deficit	(196,664)	(186,103)
Total stockholders' equity	107,482	115,898
Total liabilities and stockholders' equity	\$ 154,461	\$ 164,437

<sup>(1)</sup> Includes related party amounts of \$5,804 as of March 31, 2010 and \$6,056 as of December 31, 2009. See Note 11 for additional information on related party transactions.

*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents**

**ECHELON CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended March 31,	
	2010	2009
<b>REVENUES:</b>		
Product	\$ 17,319	\$ 17,389
Service	827	794
 Total revenues <sup>(2)</sup>	 18,146	 18,183
<b>COST OF REVENUES:</b>		
Cost of product <sup>(1)</sup>	9,167	9,640
Cost of service <sup>(1)</sup>	597	648
 Total cost of revenues	 9,764	 10,288
 Gross profit	 8,382	 7,895
<b>OPERATING EXPENSES:</b>		
Product development <sup>(1)</sup>	8,303	9,091
Sales and marketing <sup>(1)</sup>	6,497	5,722
General and administrative <sup>(1)</sup>	4,230	3,787
 Total operating expenses	 19,030	 18,600
 Loss from operations	 (10,648)	 (10,705)
Interest and other income, net	435	310
Interest expense on lease financing obligations	(402)	(425)
 Loss before provision for income taxes	 (10,615)	 (10,820)
Income tax benefit	(54)	(255)
 NET LOSS	 \$ (10,561)	 \$ (10,565)
 Net loss per share:		
Basic	\$ (0.26)	\$ (0.26)
 Diluted	 \$ (0.26)	 \$ (0.26)
 Shares used in computing net loss per share:		
Basic	41,072	40,508
 Diluted	 41,072	 40,508

## Edgar Filing: ECHELON CORP - Form 10-Q

- (1) See Note 4 for summary of amounts included representing equity compensation expense.
- (2) Includes related party amounts of \$362 and \$1,289 for the three months ended March 31, 2010 and 2009, respectively. See Note 11 for additional information on related party transactions.  
*See accompanying notes to condensed consolidated financial statements.*

**Table of Contents****ECHELON CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:</b>		
Net loss	\$ (10,561)	\$ (10,565)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,622	1,606
Reduction of allowance for doubtful accounts	(39)	(6)
Loss on disposal of fixed assets	4	
Increase in accrued investment income	(15)	(21)
Stock-based compensation	3,232	3,043
Change in operating assets and liabilities:		
Accounts receivable	7,877	10,448
Inventories	(3,599)	(4,036)
Deferred cost of goods sold	752	(322)
Other current assets	87	1,709
Accounts payable	(1,295)	(1,045)
Accrued liabilities	2,202	(382)
Deferred revenues	(1,931)	440
Deferred rent	(27)	(6)
Net cash provided by (used in) operating activities	(1,691)	863
<b>CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:</b>		
Purchases of available-for-sale short-term investments	(14,951)	(28,919)
Proceeds from maturities and sales of available-for-sale short-term investments	9,970	19,368
Change in other long-term assets	(8)	19
Capital expenditures	(464)	(604)
Net cash used in investing activities	(5,453)	(10,136)
<b>CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:</b>		
Principal payments of lease financing obligations	(383)	(349)
Proceeds from exercise of stock options	98	763
Repurchase of common stock from employees for payment of taxes on vesting of restricted stock units and upon exercise of stock options	(633)	(41)
Net cash provided by (used in) financing activities	(918)	373
EFFECT OF EXCHANGE RATE CHANGES ON CASH	(484)	(264)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(8,546)	(9,164)
<b>CASH AND CASH EQUIVALENTS:</b>		
Beginning of period	17,206	37,669



# Edgar Filing: ECHELON CORP - Form 10-Q

End of period	\$ 8,660	\$ 28,505
---------------	----------	-----------

## SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid for interest on lease financing obligations	\$ 400	\$ 423
---	--------	--------

Cash paid for income taxes	\$ 72	\$ 163
----------------------------	-------	--------

*See accompanying notes to condensed consolidated financial statements.*

---

**Table of Contents**

**ECHELON CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Summary of Significant Accounting Policies:**

***Basis of Presentation***

The condensed consolidated financial statements include the accounts of Echelon Corporation (the "Company"), a Delaware corporation, and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2009 included in its Annual Report on Form 10-K.

With the exception of the adoption of accounting pronouncements related to revenue recognition discussed in the section titled "Revenue Recognition" below, there have been no material changes to the Company's significant accounting policies, as compared to the significant accounting policies described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

***Risks and Uncertainties***

The Company's operations and performance depend significantly on worldwide economic conditions and their impact on purchases of the Company's products, as well as the ability of suppliers to provide the Company with products and services in a timely manner. The impact of any of the matters described below could have an adverse affect on the Company's business, results of operations and financial condition.

The Company's sales are currently concentrated with a relatively small group of customers, as approximately 50% of net revenues for the quarter ended March 31, 2010 was derived from five customers. Customers in any of the Company's target market sectors may experience unexpected reductions in demand for their products and reduce their purchase orders from us, resulting in either the loss of a significant customer or a notable decrease in the level of sales to a significant customer. In addition, if any of these customers are unable to obtain the necessary capital to operate their business, they may be unable to satisfy their payment obligations to the Company.

The Company utilizes third-party contract electronic manufacturers to manufacture, assemble, and test its products. As a result of current credit market conditions, if any of these third-parties were unable to obtain the necessary capital to operate their business, they may be unable to provide the Company with timely services or to make timely deliveries of products.

Due to the continuing worldwide economic crisis, coupled with the fact that the Company's NES customers generally procure products that have been customized to meet their requirements, the Company has limited visibility into ultimate product demand, which makes sales forecasting more difficult. As a result, anticipated demand may not materialize, which could subject the Company to increased levels of excess and obsolete inventories.

***Use of Estimates***

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions, and estimates that affect amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Significant estimates and judgments are used for revenue recognition, stock-based compensation, allowance for doubtful accounts, inventory valuation, allowance for warranty costs, income taxes, and other loss contingencies. In order to

## Edgar Filing: ECHELON CORP - Form 10-Q

determine the carrying values of assets and liabilities that are not readily apparent from other sources, the Company bases its estimates and assumptions on current facts, historical experience, and various other factors that it believes to be reasonable under the circumstances. Actual results experienced by the Company may differ materially from management's estimates.

---

**Table of Contents**

**ECHELON CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

***Recently Issued Accounting Standards***

There have been no new recent accounting pronouncements or changes in accounting pronouncements during the three months ended March 31, 2010, with the exception of those discussed in the section *Revenue Recognition* below, as compared to the recent accounting pronouncements described in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009, that are of significance, or potential significance, to the Company.

***Revenue Recognition***

In October 2009, the Financial Accounting Standards Board ( FASB ) amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

require an entity to allocate revenue in an arrangement using its best estimated selling price ( BESP ) of deliverables if a vendor does not have vendor-specific objective evidence ( VSOE ) of selling price or third-party evidence ( TPE ) of selling price; and

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

The Company elected to early adopt this accounting guidance at the beginning of its first quarter of fiscal year 2010 on a prospective basis for applicable transactions originating or materially modified after December 31, 2009.

***Multiple Element Arrangements***

The Company's multiple deliverable revenue arrangements are primarily related to sales of its NES System products, which may include, within a single arrangement, electricity meters and data concentrators (collectively, the Hardware ); NES System software; Element Manager software; post-contract customer support ( PCS ) for the NES System and Element Manager software; and extended warranties for the Hardware. For arrangements originating or materially modified after December 31, 2009, with the exception of the NES System software, each of these deliverables is considered a separate unit of accounting. The NES System software functions together with an electricity meter to deliver its essential functionality and any related software license fee is charged for on a per meter basis. Therefore, the NES System software and an electricity meter are combined and considered a single unit of accounting. The Element Manager software is not considered to be part of an electricity meter's essential functionality and, therefore, Element Manager software and any related PCS continues to be accounted for under industry specific software revenue recognition guidance. However, all other NES system deliverables are no longer within the scope of industry specific software revenue recognition guidance.

The Company allocates revenue to each element in a multiple-element arrangement based upon their relative selling price. The Company determines the selling price for each deliverable using VSOE of selling price or TPE of selling price, if it exists. If neither VSOE nor TPE of selling price exists for a deliverable, the Company uses its BESP for that deliverable. Since the use of the residual method is eliminated under the new accounting standards, any discounts offered by the Company are allocated to each of the deliverables. Revenue allocated to each element is then recognized when the basic revenue recognition criteria is met for the respective element.

## Edgar Filing: ECHELON CORP - Form 10-Q

Consistent with its methodology under previous accounting guidance, if available, the Company determines VSOE of fair value for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial contractual arrangement. The Company currently estimates selling prices for its PCS and extended warranties based on VSOE of fair value.

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

In many instances, the Company is not currently able to establish VSOE for all deliverables in an arrangement with multiple elements. This may be due to the Company infrequently selling each element separately or not pricing products within a narrow range. When VSOE cannot be established, the Company attempts to establish the selling price of each element based on TPE. TPE is determined based on competitor prices for similar deliverables when sold separately. Generally, the Company's offerings contain significant differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine the stand-alone selling prices for similar products of its competitors. Therefore, the Company is typically not able to determine TPE of selling price.

When the Company is unable to establish a selling price using VSOE or TPE, which is generally the case for the Hardware, the Company uses its BESP in determining the allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for new or highly customized offerings.

The Company establishes pricing for its products and services by considering multiple factors including, but not limited to, geographies, market conditions, competitive landscape, internal costs, gross margin objectives, and industry pricing practices. The determination of pricing also includes consultation with and formal approval by the Company's management, taking into consideration the Company's go-to-market strategy. Based on the Company's analysis of pricing stated in contractual arrangements for its Hardware products in historical multiple-element transactions and, to a lesser extent, historical standalone transactions, the Company has concluded that it typically prices its Hardware within a narrow range of discounts when compared to the price listed on the Company's standard pricing grid for similar deliverables (i.e., similar configuration, volume, geography, etc.). Therefore, the Company has determined that, for its current Hardware for which VSOE or TPE is not available, the Company's BESP generally is comprised of prices based on a narrow range of discounts from pricing stated in its pricing grid.

The Company regularly reviews VSOE and has established a review process for TPE and BESP. The Company maintains internal controls over the establishment and updates of these estimates. There were no material impacts during the three months ended March 31, 2010 resulting from changes in VSOE, TPE, or BESP, nor does the Company expect a material impact from such changes in the near term.

Total net revenues as reported and unaudited pro forma total net revenues that would have been reported during the three months ended March 31, 2010, if the transactions entered into or materially modified after December 31, 2009 were subject to previous accounting guidance, are shown in the following table (in thousands):

	<b>As Reported</b>	<b>Pro Forma Basis as if the Previous Accounting Guidance Were in Effect</b>
<b>Total net revenues for the three months ended March 31, 2010</b>	<b>\$ 18,146</b>	<b>\$ 18,133</b>

The impact to total net revenues during the three months ended March 31, 2010 resulting from the adoption of the new accounting guidance was to net product revenues, and related solely to sales of the Company's NES products. The impact was relatively immaterial due to the fact that virtually all of the NES revenue recorded or deferred in the first quarter of 2010 resulted from transactions that were entered into prior to January 1, 2010. However, as it relates to the timing and pattern of revenue recognition for NES product sales in the future, the Company currently expects that the new accounting guidance will have a significant effect on total net revenues for transactions entered into or materially modified after December 31, 2009. This expectation is primarily due to the fact that the Company does not currently have VSOE of fair value for most of its NES product offerings, which often resulted in deferral of revenue as discussed below. In the future, for NES arrangements subject to the new revenue recognition guidance, revenue allocated to meters and data concentrators will be recognized as those units are shipped or delivered, depending on contractual terms, and revenue allocated to PCS and extended warranties will be recognized ratably over the service period.



**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

For multiple element arrangements that were entered into prior to January 1, 2010 and that include NES System and/or Element Manager software, the Company defers the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, the Company recognizes revenues for the Hardware and software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. Revenues for PCS on the NES System and Element Manager software, as well as for extended warranties on its NES Hardware products, are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software, or the customer's acceptance of any given Hardware shipment.

***Deferred Revenue and Deferred Cost of Goods Sold***

Deferred revenue and deferred cost of goods sold result from transactions where the Company has shipped product or performed services for which all revenue recognition criteria have not yet been met. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of goods sold related to deferred service revenues includes direct labor costs and applied overhead. Once all revenue recognition criteria have been met, the deferred revenues and associated cost of goods sold are recognized.

**2. Cash Equivalents and Investments**

The Company's financial instruments consist of cash equivalents, short-term investments, accounts receivable, accounts payable, and lease financing obligations. The carrying value of the Company's financial instruments approximates fair value. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of investments, which are classified as either cash equivalents or short-term, and trade receivables. With respect to its investments, the Company has an investment policy that limits the amount of credit exposure to any one financial institution and restricts placement of the Company's investments to financial institutions independently evaluated as highly creditworthy. With respect to its trade receivables, the Company performs ongoing credit evaluations of each of its customers' financial condition. For a customer whose credit worthiness does not meet the Company's minimum criteria, the Company may require partial or full payment prior to shipment. Alternatively, prior to shipment, customers may be required to provide the Company with an irrevocable letter of credit or arrange for some other form of coverage to mitigate the risk of uncollectibility, such as a bank guarantee. Additionally, the Company establishes an allowance for doubtful accounts and sales return allowances based upon factors surrounding the credit risk of specific customers, historical trends, and other available information.

On a recurring basis, the Company measures certain of its financial assets, namely its cash equivalents and available-for-sale investments, at fair value. The Company does not have any financial liabilities measured at fair value on a recurring basis. The fair value of the Company's financial assets measured at fair value on a recurring basis was determined using the following inputs at March 31, 2010 (in thousands):

	Fair Value Measurements at Reporting Date Using			
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Total				
Money market funds <sup>(1)</sup>	\$ 1,689	\$ 1,689	\$	\$
Fixed income available-for-sale securities: <sup>(2)</sup>				
U.S. corporate commercial paper	9,997		9,997	
U.S. government securities	57,918		57,918	



# Edgar Filing: ECHELON CORP - Form 10-Q

Total fixed income available-for-sale securities	67,915		67,915	
Total	\$ 69,604	\$ 1,689	\$ 67,915	\$

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The fair value of the Company's financial assets measured at fair value on a recurring basis was determined using the following inputs at December 31, 2009 (in thousands):

	Fair Value Measurements at Reporting Date Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds <sup>(1)</sup>	\$ 1,655	\$ 1,655	\$	\$
Fixed income available-for-sale securities: <sup>(2)</sup>				
U.S. corporate commercial paper	14,991		14,991	
U.S. government securities	52,919		52,919	
Total fixed income available-for-sale securities	67,910		67,910	
Total	\$ 69,565	\$ 1,655	\$ 67,910	\$

<sup>(1)</sup> Included in cash and cash equivalents in the Company's condensed consolidated balance sheets

<sup>(2)</sup> Included in either cash and cash equivalents or short-term investments in the Company's condensed consolidated balance sheets. All of the \$67.9 million of fixed income available-for-sale securities at March 31, 2010 are classified as short-term investments. Of the \$67.9 million of fixed income available-for-sale securities at December 31, 2009, approximately \$5.0 million are classified as cash equivalents, while the remaining \$62.9 million are classified as short-term investments. Cash equivalents consist of either investments with remaining maturities of three months or less at the date of purchase, or money market funds for which the carrying amount is a reasonable estimate of fair value.

As of March 31, 2010, the Company's available-for-sale short-term investments had contractual maturities from three to twelve months and an average remaining term to maturity of five months. As of March 31, 2010, the amortized cost basis, aggregate fair value, and gross unrealized holding gains and losses of the Company's short-term investments by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. corporate commercial paper	\$ 9,997	\$ 9,997	\$	\$
U.S. government and agency securities	57,907	57,918	14	3
Total investments in debt securities	\$ 67,904	\$ 67,915	\$ 14	\$ 3

Market values were determined for each individual security in the investment portfolio. The decline in value of these investments is primarily related to changes in interest rates and is considered to be temporary in nature. The Company reviews its investments on a regular basis to evaluate whether or not any of them have experienced an other-than-temporary decline in fair value. In performing its review, the Company

## Edgar Filing: ECHELON CORP - Form 10-Q

considers factors such as the length of time and extent to which the market value has been less than the cost, the financial condition and near-term prospects of the issuer, and the Company's intent to sell (or whether it is more likely than not that the Company will be required to sell) the investment before recovery of the investment's amortized cost basis. If the Company believes that an other-than-temporary decline exists, that investment is written down to fair value. As of March 31, 2010, none of the Company's investments had any material unrealized losses.

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****3. Earnings Per Share**

The following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations for the three months ended March 31, 2010 and 2009 (in thousands, except per share amounts):

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>Net loss (Numerator):</b>		
Net loss, basic and diluted	\$ (10,561)	\$ (10,565)
<b>Shares (Denominator):</b>		
Weighted average common shares outstanding	41,072	40,508
<b>Shares used in basic computation</b>	<b>41,072</b>	<b>40,508</b>
Common shares issuable upon exercise of stock options (treasury stock method)		
<b>Shares used in diluted computation</b>	<b>41,072</b>	<b>40,508</b>
<b>Net loss per share:</b>		
Basic	\$ (0.26)	\$ (0.26)
Diluted	\$ (0.26)	\$ (0.26)

For the three months ended March 31, 2010 and 2009, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there were no potentially dilutive stock options due to the Company's net loss position. The number of stock options, stock appreciation rights, and restricted stock units (RSUs) excluded from this calculation for the three months ended March 31, 2010 and 2009 was 7,180,410, and 6,606,325, respectively.

**4. Stockholders' Equity and Employee Stock Option Plans:*****Common Stock***

In April 2008, the Company's board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company's common stock. During the quarter ended March 31, 2010, the Company did not repurchase any shares under the repurchase program. Since inception, the Company has repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of March 31, 2010, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011.

***Stock-based Compensation Expense***

The following table summarizes stock-based compensation expense for the three months ended March 31, 2010 and 2009 and its allocation within the condensed consolidated statements of operations (in thousands):

Edgar Filing: ECHELON CORP - Form 10-Q

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2010</b>	<b>2009</b>
Cost of revenues:		
Cost of product	\$ 326	\$ 332
Cost of service	30	52
Operating expenses:		
Product development	1,122	1,264
Sales and marketing	815	777
General and administrative	939	618
Total	\$ 3,232	\$ 3,043

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)*****Comprehensive Loss***

Comprehensive loss for the Company consists of net loss plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss for the three months ended March 31, 2010 and 2009 is as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
Net loss	\$ (10,561)	\$ (10,565)
Other comprehensive income (loss), net of tax:		
Foreign currency translation adjustments	(581)	(419)
Unrealized holding gains (losses) on available-for-sale securities	9	(32)
Comprehensive loss	\$ (11,133)	\$ (11,016)

***Stock Award Activity***

The total intrinsic value of options exercised during the three months ended March 31, 2010 was approximately \$255,000. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the shares.

The total fair value of restricted stock units ( RSUs ) vested and released during the quarter ended March 31, 2010 was approximately \$1.6 million. The fair value is calculated by multiplying the fair market value of the Company's stock on the vesting date by the number of shares vested.

***Equity Compensation Expense for RSUs with Financial- Based Performance Vesting Requirements***

As of March 31, 2010, there were 156,189 non-vested RSUs (with a grant date fair value of approximately \$1.2 million) that were subject to certain financial-based performance requirements that must be achieved before vesting can occur. Of these 156,189 non-vested RSUs, 31,250 (that were issued in October 2006 with a grant date fair value of approximately \$263,000) contain financial-based performance conditions that must be achieved by October 2010; and the remaining 124,939 RSUs (that were issued in May 2009 with a grant date fair value of approximately \$933,000) contain financial-based performance conditions that must be achieved by May 2014.

Through March 31, 2010, cumulative compensation expense of \$407,000 associated with the 124,939 RSUs granted in May 2009 has been recognized because the Company believes it is probable that the associated financial performance requirements will be achieved. If such requirements are not met, no compensation cost will be recognized and any recognized compensation cost will be reversed. No compensation expense has been recognized associated with the remaining 31,250 RSUs granted in October 2006 as management does not currently expect the financial performance requirements for these awards will be met.

**5. Significant Customers:**

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three months ended March 31, 2010 and 2009, the Company had two customers that accounted for a significant portion of its revenues: EBV Elektronik GmbH ( EBV ), the Company's primary distributor of its LonWorks® Infrastructure products in Europe, and Eltel Networks A/S ( Eltel ), a value added reseller of the Company's NES

## Edgar Filing: ECHELON CORP - Form 10-Q

products. For the three months ended March 31, 2010 and 2009, the percentage of the Company's revenues attributable to sales made to these customers was as follows:

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
EBV	18.1%	23.1%
Eltel	16.3%	21.6%
Total	34.4%	44.7%

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Of the percentage of sales made to EBV, approximately 1.7% for the three months ended March 31, 2009 related to sales of components the Company sold to EBV, which EBV in turn sold to one of Enel's third party meter manufacturers. Elsewhere in this document, those sales are reported as Enel Project revenues. The Company's contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2010. Please refer to Note 11, Related Parties, for additional information regarding the Company's agreements with Enel.

**6. Commitments and Contingencies:*****Legal Actions***

In April 2009, the Company received notice that the receiver for two companies that filed for the Italian law equivalent of bankruptcy protection in May 2004, Finmek Manufacturing SpA and Finmek Access SpA (collectively, the "Finmek Companies"), had filed a lawsuit under an Italian "claw back" law in Padua, Italy against the Company, seeking the return of approximately \$16.7 million in payments received by the Company in the ordinary course of business for components sold by the Company to the Finmek Companies prior to the bankruptcy filing. The Finmek Companies were among Enel's third party meters manufacturers, and from time to time through January 2004, the Company sold components to the Finmek Companies that were incorporated into the electricity meters that were manufactured by the Finmek Companies and sold to Enel SpA for the Enel Project. The Company believes that the Italian claw back law is not applicable to its transactions with the Finmek Companies, and the claims of the Finmek Companies' receiver are without merit.

From time to time, in the ordinary course of business, the Company may be subject to other legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of March 31, 2010, the amounts of which were immaterial, it is possible that the Company's results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

***Line of Credit***

The Company maintains a \$10.0 million line of credit with its primary bank, which expires on July 1, 2010. The letter of credit contains certain financial covenants requiring the Company not to exceed a certain maximum leverage ratio and to maintain a minimum level of liquid assets. As of March 31, 2010, the Company was in compliance with these covenants. As of March 31, 2010, the Company's primary bank had issued, against the line of credit, two standby letters of credit totaling \$146,000. Other than issuing standby letters of credit, the Company has never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

**7. Inventories:**

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead. When required, provisions are made to reduce excess and obsolete inventories to their estimated net realizable value. Inventories consist of the following (in thousands):

	March 31, 2010	December 31, 2009
Purchased materials	\$ 3,356	\$ 3,882



Edgar Filing: ECHELON CORP - Form 10-Q

Work-in-process	115	176
Finished goods	11,080	6,891
	\$ 14,551	\$ 10,949

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****8. Accrued Liabilities:**

Accrued liabilities consist of the following (in thousands):

	<b>March 31, 2010</b>	<b>December 31, 2009</b>
Accrued payroll and related costs	\$ 3,803	\$ 3,329
Customer deposits	1,993	
Warranty reserve	774	1,004
Accrued taxes	192	185
Other accrued liabilities	326	332
	<b>\$ 7,088</b>	<b>\$ 4,850</b>

**9. Segment Disclosure:**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company's chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer and his direct reports.

The Company operates in one principal industry segment, its reportable segment: the design, manufacture and sale of products for the controls network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company's products provide the infrastructure and support required to implement and deploy open, interoperable, control network solutions. For the electric utility industry, the Company has developed an advanced metering infrastructure system called the Networked Energy Services (NES) System. The NES System provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. All of the Company's products either incorporate or operate with the Neuron<sup>®</sup> Chip and/or the LonWorks protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LonWorks network technology and products, and custom software development. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such products and services that are appropriate for that customer's application.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa ( EMEA ); and Asia Pacific/ Japan ( APJ ). Each geographic area provides products and services to the Company's customers located in the respective region. The Company's long-lived assets include property and equipment, goodwill, loans to certain key employees, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of March 31, 2010 and December 31, 2009, long-lived assets of approximately \$40.4 million and \$41.6 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements.

The Company has three primary product lines: NES, LonWorks Infrastructure ( LWI ), and products and services sold to Enel. Summary revenue information by product line for the three months ended March 31, 2010 and 2009 is as follows (in thousands):

Edgar Filing: ECHELON CORP - Form 10-Q

	Three Months Ended March 31,	
	2010	2009
NES	\$ 5,452	\$ 5,739
LWI	12,332	11,155
Enel	362	1,289
Total	\$ 18,146	\$ 18,183

**Table of Contents****ECHELON CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

In North America, the Company sells its products primarily through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations in EMEA and APJ, value-added resellers, and local distributors. Revenues are attributed to geographic areas based on the country where the customer is domiciled. Summary revenue information by geography for the three months ended March 31, 2010 and 2009 is as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
Americas	\$ 6,540	\$ 4,118
EMEA	9,139	11,912
APJ	2,467	2,153
Total	\$ 18,146	\$ 18,183

For information regarding the Company's major customers, please refer to Note 5, Significant Customers.

**10. Income Taxes:**

The income tax benefit for the three months ended March 31, 2010 and 2009 was \$54,000 and \$255,000, respectively. The difference between the statutory rate and the Company's effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits.

As of March 31, 2010 and December 31, 2009, the Company had gross unrecognized tax benefits of approximately \$4.5 million and \$4.6 million, respectively, of which \$704,000 and \$802,000, respectively, if recognized, would impact the effective tax rate on income from continuing operations. The Company's policy is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. As of March 31, 2010 and December 31, 2009, the Company had accrued \$164,000 and \$224,000, respectively, for interest and penalties. The \$60,000 reduction in accrued interest and penalties during the three months ended March 31, 2010 was primarily attributable to the expiration of the statute of limitations in certain foreign jurisdictions.

**11. Related Parties:**

The law firm of Wilson Sonsini Goodrich & Rosati, P.C. acts as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, our Executive Chairman, M. Kenneth Oshman, uses his private plane or charter aircraft for Company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby our company will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During the quarter ended March 31, 2010, we recognized a total of approximately \$50,000 in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations. The Audit Committee of the Company's Board of Directors regularly reviews these reimbursements.

In November 2009, our Board of Directors approved a similar reimbursement arrangement for our President and Chief Executive Officer, Robert R. Maxfield, whereby our company will reimburse Mr. Maxfield for 50% of the costs incurred for charter aircraft used while on company

## Edgar Filing: ECHELON CORP - Form 10-Q

business. During the quarter ended March 31, 2010, there were no expenses incurred pursuant to Mr. Maxfield's reimbursement arrangement.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for \$130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. A representative of Enel is not presently serving on our board.

**Table of Contents**

**ECHELON CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the "R&D Agreement"). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LONWORKS technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2010, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the three months ended March 31, 2010 and 2009, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$362,000 and \$1.3 million, respectively. As of March 31, 2010, and December 31, 2009, \$5.8 million and \$6.1 million, respectively, of the Company's total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

On October 29, 2001, the Company loaned Russell Harris, its Senior Vice President of Operations, \$1,000,000 in connection with his principal residence. Mr. Harris issued to the Company a promissory note secured by residential real estate. The note bore interest at the rate of 4.5% per annum, compounded monthly. The interest that accrued under the note was due and payable in monthly installments over the nine year term of the note, and the principal was due and payable on October 29, 2010. The principal was paid in full by Mr. Harris in June 2009. During the quarter ended March 31, 2009, interest paid by Mr. Harris was \$11,000. While it was outstanding, the terms of this loan were never amended.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as we believe, expect, anticipate, intend, plan, goal, continues, may, and similar expressions. In addition, forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the Factors That May Affect Future Results of Operations section. Our actual results may differ materially.*

**EXECUTIVE OVERVIEW**

Echelon Corporation was incorporated in California in February 1988 and reincorporated in Delaware in January 1989. We are based in San Jose, California, and maintain offices in eleven foreign countries throughout Europe and Asia. We develop, market, and sell system and network infrastructure products that enable everyday devices such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity and enhance service, quality, safety, and convenience. We offer these hardware and software products and related services to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

For the last several years, we have been investing heavily in the development of hardware and software products for the advanced metering infrastructure, or AMI, market. These AMI products are used by the electric utility industry in their distribution and metering systems, and are components of what is commonly referred to as the smart grid. To date, we have generated revenues of approximately \$193.2 million from these investments. We refer to this revenue as networked energy services, or NES, revenue. We also sell certain of our products to Enel and certain suppliers of Enel for use in Enel's Contatore Elettronico electricity meter management project in Italy. We refer to Echelon's revenue derived from sales to Enel and Enel's designated manufacturers as Enel Project revenue. We refer to all other revenue as LonWorks Infrastructure, or LWI, revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

While our total revenues remained relatively flat during the first quarter of 2010 as compared to the same period in 2009, our gross margins improved by 2.8 percentage points. That benefit, however, was offset by a 2.3% increase in our operating expenses. The net effect was a first quarter loss in 2010 that was virtually identical to the loss generated in the first quarter of 2009.

The following tables provide an overview of key financial metrics for the quarters ended March 31, 2010 and 2009 that our management team focuses on in evaluating our financial condition and operating performance (in millions, except percentages).

	<b>Three Months Ended March 31,</b>			
	<b>2010</b>	<b>2009</b>	<b>\$ Change</b>	<b>% Change</b>
Net revenues	\$ 18,146	\$ 18,183	\$ (37)	(0.2%)
Gross margin	46.2%	43.4%		2.8 ppt
Operating expenses	\$ 19,030	\$ 18,600	\$ 430	2.3%
Net loss	\$ (10,561)	\$ (10,565)	\$ 4	0.0%

**Table of Contents**

	Balance as of			
	March 31, 2010	December 31, 2009	\$ Change	% Change
Cash, cash equivalents, and short-term investments	\$ 76,575	\$ 80,116	\$ (3,541)	(4.4%)

*Net revenues:* While our total revenues remained relatively flat during the first quarter of 2010 as compared to the same period in 2009, we saw a 10.6% improvement in our LWI revenues between the two periods, which was offset by a 5.0% decrease in our NES revenues and a 71.9% decrease in our Enel Project revenues. While we experienced modest improvement in our LWI revenues during the first quarter of 2010, we continue to believe that our revenue levels have been adversely affected by the severe economic downturn that began in late 2008 and has continued since then. Utilities are the ultimate customer for our NES products. We believe that utilities have limited capital expenditures in response to reduced cash flow arising from the worldwide recession. In the United States we believe that utilities have further delayed decisions pending the distribution of stimulus awards from the United States Department of Energy. With respect to the LWI product line, many of our customers produce products used in commercial or industrial buildings. The markets for these products were adversely affected by the recession. However, the company has seen strength in energy saving markets such as demand response. The reduction in our Enel Project revenues was primarily due to an anticipated decrease in the level of orders placed by Enel's meter manufacturers for metering kits under the 2006 development and supply agreement.

*Gross margin:* Our gross margin improved by 2.8 percentage points during the first quarter of 2010 as compared to the same period in 2009. Excluding the impact of non-cash stock-based compensation charges, gross margins improved by 2.7%, from 45.5% in the first quarter of 2009 to 48.2% in the first quarter of 2010. This improvement was primarily due to higher gross margins generated from sales of our NES products, which was the direct result of both continued investments we have made in engineering to develop products that cost less to build, as well as work we have done with our third party contract electronic manufacturers to reduce their costs.

*Operating expenses:* Our operating expenses increased by 2.3% during the first quarter of 2010 as compared to the same period in 2009. Excluding the impact of non-cash stock-compensation charges, operating expenses increased by 1.3%, from \$15.9 million in the first quarter of 2009 to \$16.2 million in the first quarter of 2010.

*Net loss:* Our net loss was virtually unchanged during the first quarter of 2010 as compared to the same period in 2009. Excluding the impact of non-cash stock-compensation charges, our net loss decreased by \$193,000, from \$7.5 million in the first quarter of 2009 to \$7.3 million in the first quarter of 2010. While gross margins improved between the two periods, that benefit was offset by higher operating expenses.

*Cash, cash equivalents, and short-term investments:* During the first quarter of 2010, our cash, cash equivalent, and short-term investment balance decreased by 4.4%, from \$80.1 million at December 31, 2009 to \$76.6 million at March 31, 2010. This \$3.5 million reduction was primarily the result of \$1.7 million of cash used in operating activities, and to a lesser extent by cash used in investing and financing activities.

We believe that 2010 will continue to present a challenging economic environment in the markets we serve. However, we are cautiously optimistic that conditions will begin to improve during the second half of the year. This belief is dependent on many macro-economic factors, including market improvement for the products our LWI customers sell that incorporate our technology, resolution of United States stimulus funding, and timely resolution of regulatory processes. Our management team remains focused on working to ensure that our company is properly positioned to capitalize on existing customer relationships, as well as new opportunities as they become available. For example, we continue to invest strategically in the development of new technologies and products to increase our share of the network infrastructure market, including technologies and products specifically aimed at the smart grid and other green initiatives. We also continue to enhance our sales and marketing efforts in a variety of ways, including adding to our existing base of third party value added resellers, initiating new sales channel programs, and hiring new employees to cover critical areas.



## Table of Contents

### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. Note 1, "Significant Accounting Policies" of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2009, which we filed with the Securities and Exchange Commission in March 2010, describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our revenues, stock-based compensation, allowance for doubtful accounts, inventories, and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

With the exception of a change in our accounting policy for revenue recognition, which is more fully described below, during the three months ended March 31, 2010 there were no material changes to our critical accounting policies or in the matters for which we make critical accounting estimates in the preparation of our condensed consolidated financial statements as compared to those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009.

**Revenue Recognition.** Our revenues are derived from the sale and license of our products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to our customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For non-distributor hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For sales made to our distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer.

We account for the rights of return, price protection, rebates, and other sales incentives offered to distributors of our products as a reduction in revenue. With the exception of sales to distributors, the Company's customers are generally not entitled to return products for a refund. For sales to distributors, due to contractual rights of return and other factors that impact our ability to make a reasonable estimate of future returns and other sales incentives, revenues are not recognized until the distributor has shipped our product to the end customer.

In most instances involving large-scale deployments, our NES System products are sold as part of multiple element arrangements. These arrangements may require us to deliver our NES System products and services over an extended period of time. In October 2009, the FASB amended the accounting standards for multiple deliverable revenue arrangements to:

provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

require an entity to allocate revenue in an arrangement using its best estimated selling price ( "BESP" ) of deliverables if a vendor does not have vendor-specific objective evidence ( "VSOE" ) of selling price or third-party evidence ( "TPE" ) of selling price; and

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

We elected to early adopt this accounting guidance January 1, 2010 on a prospective basis for applicable transactions originating or materially modified after December 31, 2009.

## **Table of Contents**

As noted above, our multiple deliverable revenue arrangements are primarily related to sales of our NES System products, which may include, within a single arrangement, electricity meters and data concentrators (collectively, the Hardware); NES System software; Element Manager software; post-contract customer support (PCS) for the NES System and Element Manager software; and extended warranties for the Hardware. For arrangements originating or materially modified after December 31, 2009, with the exception of the NES System software, each of these deliverables is considered a separate unit of accounting. The NES System software functions together with an electricity meter to deliver its essential functionality and any related software license fee is charged for on a per meter basis. Therefore, the NES System software and an electricity meter are combined and considered a single unit of accounting. The Element Manager software is not considered to be part of an electricity meter's essential functionality and, therefore, Element Manager software and any related PCS continues to be accounted for under industry specific software revenue recognition guidance. However, all other NES system deliverables are no longer within the scope of industry specific software revenue recognition guidance.

We allocate revenue to each element in a multiple-element arrangement based upon the element's relative selling price. We determine the selling price for each deliverable using VSOE of selling price or TPE of selling price, if it exists. If neither VSOE nor TPE of selling price exists for a deliverable, we use our BESP for that deliverable. Since the use of the residual method has been eliminated under the new accounting standards, any discounts we offer are allocated to each of the deliverables. Revenue allocated to each element is then recognized when the basic revenue recognition criteria is met for the respective element.

Consistent with our methodology under previous accounting guidance, if available, we determine VSOE of fair value for each element based on historical stand-alone sales to third parties or from the stated renewal rate for the elements contained in the initial contractual arrangement. We currently estimate the selling prices for our PCS and extended warranties based on VSOE of fair value.

In many instances, we are not currently able to establish VSOE for all deliverables in an arrangement with multiple elements. This may be due to the fact that we infrequently sell each element separately or that we do not price products within a narrow range. When VSOE cannot be established, we attempt to establish the selling price of each element based on TPE. TPE is determined based on our competitor's prices for similar deliverables when sold separately. However, in general, our offerings contain significant differentiation from our competition such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, we are unable to reliably determine the stand-alone selling prices for similar products of our competitors. Therefore, we typically are not able to determine TPE of selling price.

When we are unable to establish a selling price using VSOE or TPE, which is generally the case for the Hardware, we use our BESP in determining the allocation of arrangement consideration. The objective of BESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. BESP is generally used for offerings that are not typically sold on a stand-alone basis or for new or highly customized offerings.

We establish pricing for our products and services by considering multiple factors including, but not limited to, geographies, market conditions, competitive landscape, internal costs, gross margin objectives, and industry pricing practices. The determination of pricing also includes consultation with and formal approval by our management, taking into consideration our go-to-market strategy. Based on our analysis of pricing stated in contractual arrangements for our Hardware products in historical multiple-element transactions and, to a lesser extent, historical standalone transactions, we have concluded that we typically price our Hardware within a narrow range of discounts when compared to the price listed on our standard pricing grid for similar deliverables (i.e., similar configuration, volume, geography, etc.). Therefore, we have determined that, for our current Hardware for which VSOE or TPE is not available, our BESP generally is comprised of prices based on a narrow range of discounts from pricing stated in our pricing grid.

We regularly review VSOE and have established a review process for TPE and BESP. We maintain internal controls over the establishment and updates of these estimates. There were no material impacts during the three months ended March 31, 2010 resulting from changes in VSOE, TPE, or BESP, nor do we expect a material impact from such changes in the near term.

**Table of Contents**

Total net revenues as reported and unaudited pro forma total net revenues that would have been reported during the three months ended March 31, 2010, if the transactions entered into or materially modified after December 31, 2009 were subject to previous accounting guidance, are shown in the following table (in thousands):

	<b>As Reported</b>	<b>Pro Forma Basis as if the Previous Accounting Guidance Were in Effect</b>
Total net revenues for the three months ended March 31, 2010	\$ 18,146	\$ 18,133

The impact to total net revenues during the three months ended March 31, 2010 resulting from the adoption of the new accounting guidance was to net product revenues, and related solely to sales of our NES products. The impact was relatively immaterial due to the fact that virtually all of the NES revenue recorded or deferred in the first quarter of 2010 resulted from transactions that were entered into prior to January 1, 2010. However, as it relates to the timing and pattern of revenue recognition for NES product sales in the future, we currently expect that the new accounting guidance will have a significant effect on total net revenues for transactions entered into or materially modified after December 31, 2009. This expectation is primarily due to the fact that we do not currently have VSOE of fair value for most of our NES product offerings, which often resulted in deferral of revenue as discussed below. In the future, for NES arrangements subject to the new revenue recognition guidance, revenue allocated to meters and data concentrators will be recognized as those units are shipped or delivered, depending on contractual terms, and revenue allocated to PCS and extended warranties will be recognized ratably over the service period.

For multiple element arrangements that were entered into prior to January 1, 2010 and that include NES System and/or Element Manager software, we defer the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, we recognize revenues for the Hardware and software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. Revenues for PCS on the NES System and Element Manager software, as well as for extended warranties on its NES Hardware products, are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software, or the customer's acceptance of any given Hardware shipment.

**Table of Contents****RESULTS OF OPERATIONS**

The following table reflects the percentage of total revenues represented by each item in our Consolidated Statements of Operations for the three months ended March 31, 2010 and March 31, 2009:

	<b>Three Months Ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
Revenues:		
Product	95.4%	95.6%
Service	4.6	4.4
Total revenues	100.0	100.0
Cost of revenues:		
Cost of product	50.5	53.0
Cost of service	3.3	3.6
Total cost of revenues	53.8	56.6
Gross profit	46.2	43.4
Operating expenses:		
Product development	45.8	50.0
Sales and marketing	35.8	31.5
General and administrative	23.3	20.8
Total operating expenses	104.9	102.3
Loss from operations	(58.7)	(58.9)
Interest and other income, net	2.4	1.7
Interest expense on lease financing obligations	(2.2)	(2.3)
Loss before provision for income taxes	(58.5)	(59.5)
Provision for income taxes	(0.3)	(1.4)
Net loss	(58.2)%	(58.1)%

**Revenues****Total revenues**

	<b>Three Months Ended</b>			
	<b>March 31,</b>	<b>March 31,</b>	<b>2010 over</b>	<b>2010 over</b>
	<b>2010</b>	<b>2009</b>	<b>2009 \$</b>	<b>2009 %</b>
			<b>Change</b>	<b>Change</b>
<i>(Dollars in thousands)</i>				
Total revenues	\$ 18,146	\$ 18,183	\$ (37)	(0.2)%

The \$37,000 decrease in total revenues for the quarter ended March 31, 2010 as compared to the same period in 2009 was primarily the result of a \$927,000 decrease in Enel project revenues and a \$287,000 decrease in NES revenues; partially offset by a \$1.2 million increase in LWI revenues.

**NES revenues**

	Three Months Ended		2010 over 2009 \$ Change	2010 over 2009 % Change
	March 31, 2010	March 31, 2009		
<i>(Dollars in thousands)</i>				
NES revenues	\$ 5,452	\$ 5,739	\$ (287)	(5.0)%

## **Table of Contents**

During the quarters ended March 31, 2010 and 2009, our NES revenues were derived primarily from a relatively small number of customers who have undertaken large-scale deployments of our NES System products. These deployments generally come to fruition after an extended and complex sales process, and each is relatively substantial in terms of its revenue potential. They vary significantly from one another in terms of, among other things, the overall size of the deployment, the duration of time over which the products will be sold, the mix of products being sold, the timing of delivery of those products, and the ability to modify the timing or size of those projects. This relative uniqueness among each deployment results in significant variability and unpredictability in our NES System revenues.

The \$287,000 decrease in NES revenues during the quarter ended March 31, 2010 as compared to the same period in 2009 was due to an overall reduction in the level of large-scale deployments of our NES System products.

Our ability to recognize revenue on shipments of our NES products depends on several factors, including, but not limited to, the impact on delivery dates of any modifications to existing shipment schedules included in the contracts that have been awarded to us thus far, and certain contractual provisions, such as customer acceptance. In addition, the complex revenue recognition rules relating to products such as our NES System will likely require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period. Although we adopted new accounting guidance for multiple element arrangements during the first quarter of 2010 (which is discussed more fully in the section titled Critical Accounting Policies and Estimates earlier in this section), that guidance will only apply to transactions entered into or materially modified after December 31, 2009. In the meantime, orders booked prior to 2010 will continue to be accounted for under previous revenue recognition guidance. For those orders, our ability to recognize revenue associated with sales of our NES products will continue to be affected by the factors discussed in our NES revenues discussion in our Annual Report on Form 10-K for the year ended December 31, 2009. As of March 31, 2010 and December 31, 2009, approximately \$4.4 million and \$5.2 million, respectively, of NES revenue was deferred, virtually all of which related to transactions that we will account for under the previous revenue recognition accounting guidance.

We also expect that some foreign utilities will require us to price our NES System in the respective utility's local currency, which will expose us to foreign currency risk. To date, we have not hedged any of these foreign currency risks because the amounts involved have been immaterial. In most cases, in the event of a significant contract award that requires us to price our NES products in the customer's local currency, we intend to hedge this foreign currency risk so long as we can secure forward currency contracts that are reasonably priced and that are consistent with the scheduled deliveries for that project.

In addition, we will face foreign currency exposures from the time we submit any foreign currency denominated bid until the award of a contract by the utility (the bid to award term). This bid to award term can often exceed several months. If a utility awards us a contract that gives the utility the right to exercise options for additional supply in the future, we would also be exposed to foreign currency risk until such time as these options, if any, were exercised. We may decide that it is too expensive to hedge the foreign currency risks during the bid to award term or for any unexercised options. Any resulting adverse foreign currency fluctuations could significantly harm our revenues, results of operations, and financial condition.

Lastly, our NES revenues have historically been concentrated with a relatively few customers. During the years ended December 31, 2009, 2008, and 2007, approximately 85.4%, 93.1%, and 91.6%, respectively, of our NES revenues were attributable to five customers. Given the nature of the NES market, we expect this concentration will continue in 2010.

During 2009, our NES revenues decreased by approximately 28.1% as compared to 2008. We believe this reduction was due, at least in part, to the sudden and severe worldwide economic slowdown that began in late 2008 and continued through 2009. As a result of the recession, utilities have experienced reduced cash flows, which we believe has caused them to limit their capital expenditures. In addition, the economic downturn has had a particularly detrimental effect on the credit markets, both in the United States and abroad, which play a key role in a utility's decision to move forward with a large-scale deployment, as such efforts frequently require the utility to secure financing for the project. We also believe that the American Recovery and Reinvestment Act of 2009, which was enacted in early 2009, caused many U.S. utilities to postpone their plans to move forward with their large-scale AMI deployments. This was due to the fact that, once the stimulus program was announced, utilities throughout the United States applied for stimulus funds in order to offset a portion of their project's expected costs. While the stimulus awards were announced in late 2009, many recipients have continued to delay their projects until they are able to finalize the terms and conditions of their grant with the U.S. Department of Energy.

**Table of Contents**

We currently expect that our 2010 NES System revenues will increase modestly over 2009 levels, in part due to our expectation that world-wide macro-economic conditions and associated credit markets, which were severely impacted by the recession, will begin to improve. We also remain cautiously optimistic that the stimulus effect of the American Recovery and Reinvestment Act of 2009, particularly as it relates to those funds allocated to AMI initiatives, will begin to be realized in the second half of 2010, which could enable some of our customers to increase or speed up their purchases of our products.

**LWI revenues**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
(Dollars in thousands)				
LWI revenues	\$ 12,332	\$ 11,155	\$ 1,177	10.6%

Our LWI revenues are primarily comprised of sales of our hardware and software products, and to a lesser extent, revenues we generate from our customer support and training offerings. The \$1.2 million increase in LWI revenue for the quarter ended March 31, 2010 as compared to the same period in 2009 was primarily due to a \$1.4 million increase in LWI revenues from the Americas and a \$504,000 increase in APJ; partially offset by a \$703,000 reduction in sales in the EMEA region. Although sales in the Americas increased during the first quarter of 2010, the majority of this improvement was concentrated with one customer. We do not currently expect to maintain a similar level of business with that customer for each of the remaining quarters in 2010. Apart from that particular customer's increased revenues during the first quarter, we continue to observe the detrimental effects the worldwide recession has had on our customers in both the Americas and EMEA regions. While the economy in the United States appears to be showing signs of improvement, we have not yet seen any such improvement in EMEA. Within the LWI family of products, the \$1.2 million increase was primarily attributable to an increase in sales of our SmartServer products.

Our future LWI revenues will continue to be subject to fluctuations in the exchange rates between the United States dollar and the foreign currencies in which we sell our LWI products and services. In general, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. Conversely, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would decrease. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in these currencies and the magnitude of the exchange rate fluctuation from year to year. The portion of our LWI revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was about 7.9% for the quarter ended March 31, 2010 and 7.2% for the same period in 2009. To date, we have not hedged any of these foreign currency risks. We do not currently expect that, in the near future, the amount of our LWI revenues conducted in these foreign currencies will fluctuate significantly from prior year levels. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our revenues conducted in foreign currencies were to grow significantly, we would re-evaluate these exposures and, if necessary, enter into hedging arrangements to help minimize these risks.

As with our NES revenues, we currently expect our full 2010 LWI revenues will increase modestly over amounts generated in 2009, due primarily to our expectation of improved macro-economic conditions in certain of the markets we serve.

**Enel project revenues**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
(Dollars in thousands)				
Enel project revenues	\$ 362	\$ 1,289	\$ (927)	(71.9)%

In October 2006, we entered into two agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel is purchasing additional metering kit and data concentrator products from us. Under the software enhancement agreement, we are providing software enhancements to Enel for use in its Contatore Elettronico system. The \$362,000 and \$1.3 million of Enel project revenue recognized during the quarters ended March 31, 2010 and 2009, respectively, related primarily to shipments under the new development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2010, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

## Edgar Filing: ECHELON CORP - Form 10-Q

We currently expect that revenues from the Enel project during 2010 will be significantly less than those generated in 2009.



**Table of Contents**

We sell our products to Enel and its designated manufacturers in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency risks.

**Gross Profit and Gross Margin**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
<i>(Dollars in thousands)</i>				
Gross Profit	\$ 8,382	\$ 7,895	\$ 487	6.2%
Gross Margin	46.2%	43.4%		2.8

Gross profit is equal to revenues less cost of goods sold. Cost of goods sold for product revenues includes direct costs associated with the purchase of components, subassemblies, and finished goods, as well as indirect costs such as allocated labor and overhead; costs associated with the packaging, preparation, and shipment of products; and charges related to excess and obsolete inventory reserves, warranty costs, and purchase price variances. Cost of goods sold for service revenues consists of employee-related costs such as salaries and fringe benefits as well as other direct and indirect costs incurred in providing training, customer support, and custom software development services. Gross margin is equal to gross profit divided by revenues.

The 2.8 percentage point increase in gross margin during the first quarter of 2010 was due primarily to improvement in gross margins generated from our NES product line, which resulted from a higher percentage of our NES revenues being attributable to sales of the more recent, cost reduced versions of our NES products. As a percentage of revenues, indirect costs were relatively unchanged during the quarter ended March 31, 2010 as compared to the same period in 2009.

Our future gross margins will continue to be affected by several factors, including, but not limited to: overall revenue levels; changes in the mix of products sold; periodic charges related to excess and obsolete inventories, warranty expenses; introductions of cost reduced versions of our NES and LWI products; changes in the average selling prices of the products we sell; purchase price variances; and fluctuations in the level of indirect overhead spending that is capitalized in inventory. In addition, the impact of foreign exchange rate fluctuations may affect our gross margins in the future. We currently outsource the manufacturing of most of our products requiring assembly to CEMs located primarily in China. To the extent the dollar were to weaken against the Chinese currency, or other currencies used by our CEMs, our costs for the products they manufacture could rise, which would negatively affect our gross margins. Lastly, many of our products, particularly our NES products, contain significant amounts of certain commodities, such as copper and cobalt. Prices for these commodities have been volatile, which in turn have caused fluctuations in the prices we pay for the products in which they are incorporated.

**Operating Expenses****Product Development**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
<i>(Dollars in thousands)</i>				
Product Development	\$ 8,303	\$ 9,091	\$ (788)	(8.7)%

**Table of Contents**

Product development expenses consist primarily of payroll and related expenses for development personnel, facility costs, expensed material, fees paid to third party service providers, depreciation and amortization, and other costs associated with the development of new technologies and products.

The \$788,000 decrease in product development expenses during the quarter ended March 31, 2010 as compared to the same period in 2009 was primarily due to a \$387,000 decrease in compensation expenses for our product development personnel, which was primarily the result of a structured salary reduction program we implemented in May 2009 for our U.S. based personnel, as well as a reduction of \$142,000 in equity compensation expense. The remaining decrease was due to less significant changes in various other spending categories.

In April 2010, we announced that our Board of Directors had approved a restoration of salary for all of our employees who had been affected by the structured salary reduction we implemented in 2009. The salary restoration will take effect on May 1, 2010. Accordingly, we expect our compensation related product development expenses will increase modestly from recent levels.

**Sales and Marketing**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
<i>(Dollars in thousands)</i>				
Sales and Marketing	\$ 6,497	\$ 5,722	\$ 775	13.5%

Sales and marketing expenses consist primarily of payroll and related expenses for sales and marketing personnel, including commissions to sales personnel, travel and entertainment, facilities costs, advertising and product promotion, and other costs associated with our sales and support offices.

The \$775,000 increase in sales and marketing expenses for the quarter ended March 31, 2010 as compared to the same period in 2009 was primarily due to a \$613,000 increase in compensation related expenses, and to a lesser extent, by an increase in fees paid to third party service providers. The increase in compensation expenses was primarily due to additional headcount, as well as increased commission expenses. Also contributing to the increase was the impact of foreign currency exchange rate fluctuations between the U.S. dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the British Pound Sterling, and the Japanese Yen. Approximately \$94,000, or 12.1%, of the \$775,000 quarter-over-quarter increase was the result of these foreign currency exchange rate fluctuations. Excluding the impact of these exchange rate fluctuations, sales and marketing expenses increased by approximately 11.9% between the two periods.

Our sales personnel were not affected by the structured salary reduction program we implemented in May 2009, although our U.S. based marketing personnel were. Therefore, our future compensation related sales and marketing expenses will not be affected as significantly as a result of the May 2010 salary restoration discussed above. However, our future sales and marketing expenses will continue to be affected by fluctuations in exchange rates between the U.S. dollar and the foreign currencies where we operate. If the United States dollar were to weaken against these currencies, our sales and marketing expenses could increase. Conversely, if the dollar were to strengthen against these currencies, it would have a favorable impact on our sales and marketing expenses.

**General and Administrative**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
<i>(Dollars in thousands)</i>				
General and Administrative	\$ 4,230	\$ 3,787	\$ 443	11.7%

General and administrative expenses consist primarily of payroll and related expenses for executive, finance, and administrative personnel, professional fees for legal and accounting services rendered to the company, facility costs, insurance, and other general corporate expenses.

**Table of Contents**

The \$443,000 increase in general and administrative expenses during the quarter ended March 31, 2010 as compared to the same period in 2009 was primarily attributable to a \$321,000 increase in non-cash equity compensation expense, and to a lesser extent, by increases in fees paid to our independent accountants, outside counsel, and other third party service providers.

In April 2010, we announced that our Board of Directors had approved a restoration of salary for all of our employees who had been affected by the structured salary reduction we implemented in 2009. The salary restoration will take effect on May 1, 2010. Accordingly, we expect our compensation related general and administrative expenses will increase modestly from recent levels.

**Interest and Other Income, Net**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
<i>(Dollars in thousands)</i>				
Interest and Other Income, Net	\$ 435	\$ 310	\$ 125	40.3%

Interest and other income, net primarily reflects interest earned by our company on cash and short-term investment balances as well as foreign exchange translation gains and losses related to short-term intercompany balances.

The \$125,000 increase in interest and other income, net during the quarter ended March 31, 2010 as compared to the same period in 2009 was primarily attributable to a \$230,000 increase in foreign currency translation gains between the two periods, partially offset by a \$107,000 reduction in interest income. The increase in foreign currency translation gains is due to our foreign currency denominated short-term intercompany balances. We account for translation gains and losses associated with these balances by reflecting these amounts as either other income or loss in our consolidated statements of operations. During periods when the U.S. dollar weakens in value against these foreign currencies, the associated translation losses negatively impact other income. Conversely, when the U.S. dollar strengthens, as it did during the first quarter of 2010, the resulting translation gains favorably impact other income. The reduction in interest income is primarily the result of a reduction in our average invested cash balance between the periods coupled with reductions in the weighted average yield on our investment portfolio.

We do not currently anticipate interest income on our investment portfolio will improve significantly during 2010 as we expect interest rates to remain historically low. Future gains or losses associated with translating our foreign currency denominated short-term intercompany balances will depend on exchange rates in effect at the time of translation.

**Interest Expense on Lease Financing Obligations**

	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
<i>(Dollars in thousands)</i>				
Interest Expense on Lease Financing Obligations	\$ 402	\$ 425	\$ (23)	(5.4)%

The monthly rent payments we make to our lessor under the lease agreements for our San Jose headquarters site are recorded in our financial statements partially as land lease expense, with the remainder being allocated to principal and interest on the financing liability. Interest expense on lease financing obligations reflects the portion of our monthly lease payments that is allocated to interest expense.

The \$23,000 decrease in interest expense on lease financing obligations during the quarter ended March 31, 2010 as compared to the same period in 2009 was a result of the nature of this expense. As with any amortizing fixed rate loan, payments made earlier in the term of the loan are comprised primarily of interest expense with little being allocated to principal repayment. Payments made later in the term of the loan, however, have an increasing proportion of principal repayment, with less being attributable to interest expense. Accordingly, as we continue to make payments in accordance with our lease obligation, we expect a higher proportion of the payments we make in the future will be allocated to principal repayment and less will be allocated to interest expense.



**Table of Contents****Income Tax Benefit**

(Dollars in thousands)	Three Months Ended		2010 over	2010 over
	March 31, 2010	March 31, 2009	2009 \$ Change	2009 % Change
Income Tax Benefit	\$ (54)	\$ (255)	\$ 201	(78.8)%

The income tax benefit for the quarters ended March 31, 2010 and 2009 was \$54,000 and \$255,000, respectively. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits. The income tax benefits recorded during the quarters ended March 31, 2010 and 2009 were primarily due to the expiration of the statute of limitations in certain foreign jurisdictions.

**OFF-BALANCE-SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS**

**Off-Balance-Sheet Arrangements.** We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose our company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.

**Lease Commitments.** In December 1999, we entered into a lease agreement with a real estate developer for our existing corporate headquarters in San Jose, California. In October 2000, we entered into a second lease agreement with the same real estate developer for an additional building at our headquarters site. These leases were scheduled to expire in 2011 and 2013, respectively.

Effective June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately \$48.9 million. Both leases permit us to exercise an option to extend the respective lease for two sequential five-year terms. In addition, the amended leases eliminated our requirement to provide the landlord with security deposits totaling \$6.2 million, which we had previously satisfied through the issuance of standby letters of credit ( LOCs ). As of June 30, 2008, the previously issued LOCs had been returned to the bank that issued them and were cancelled.

In addition, we lease facilities under operating leases for our sales, marketing, and product development personnel located elsewhere within the United States and in ten foreign countries throughout Europe and Asia, including a land lease for accounting purposes associated with our corporate headquarters facilities. These operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, we also lease certain equipment and, for some of our sales personnel, automobiles. These operating leases are generally less than five years in duration.

**Purchase Commitments.** We utilize several contract manufacturers who manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts generally cover periods that range from one to six months, and in some cases, up to one year. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods ranging from one to nine months.

We also utilize purchase orders when procuring capital equipment, supplies, and services necessary for our day-to-day operations. These purchase orders generally cover periods ranging up to twelve months, but in some instances cover a longer duration.

## **Table of Contents**

**Indemnifications.** In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant. However, we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer's or director's lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that would enable us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

**Royalties.** We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which was recorded as cost of products revenue in our consolidated statements of income, was approximately \$127,000 during the quarter ended March 31, 2010, and \$118,000 for the same period in 2009.

We will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of our products. While we are currently unable to estimate the maximum amount of these future royalties, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

**Taxes.** We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon's operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of March 31, 2010, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

**Legal Actions.** In April 2009, the Company received notice that the receiver for two companies that filed for the Italian law equivalent of bankruptcy protection in May 2004, Finmek Manufacturing SpA and Finmek Access SpA (collectively, the Finmek Companies), had filed a lawsuit under an Italian claw back law in Padua, Italy against Echelon, seeking the return of approximately \$16.7 million in payments received by Echelon in the ordinary course of business for components we sold to the Finmek Companies prior to the bankruptcy filing. The Finmek Companies were among Enel's third party meters manufacturers, and from time to time through January 2004, we sold components to the Finmek Companies that were incorporated into the electricity meters that were manufactured by the Finmek Companies and sold to Enel SpA for the Enel Project. We believe that the Italian claw back law is not applicable to our transactions with the Finmek Companies, and the claims of the Finmek Companies' receiver are without merit.

From time to time, in the ordinary course of business, we are subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of March 31, 2010, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during the years 2002 through 2004, we were also able to finance our operations through operating cash flow. From inception through March 31, 2010, we raised \$293.6 million from the sale of preferred stock and common stock, including the exercise of stock options and warrants from our employees and directors.

In March and August 2004, March 2006, and February 2007, our board of directors approved a stock repurchase program, which authorized us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. Since inception, we have repurchased a total of 2,204,184 shares under the program at a cost of \$16.1 million. The stock repurchase program expired in March 2008.

In April 2008, our board of directors approved a new stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases under the new stock repurchase program during the quarter ended March 31, 2010. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of March 31, 2010, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011.

The following table presents selected financial information as of March 31, 2010, and for each of the last three fiscal years (dollars in thousands):

	December 31,			
	March 31,			
	2010	2009	2008	2007
Cash, cash equivalents, and short-term investments.	\$ 76,575	\$ 80,116	\$ 87,316	\$ 107,190
Trade accounts receivable, net	13,665	21,496	23,480	33,469
Working capital	88,648	96,357	108,811	126,711
Stockholders' equity	107,482	115,898	132,571	153,211

As of March 31, 2010, we had \$76.6 million in cash, cash equivalents, and short-term investments, a decrease of \$3.5 million as compared to December 31, 2009. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options and warrants by our employees and directors. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase program.

**Cash flows from operating activities.** Cash flows from operating activities have historically been driven by net income (loss) levels; adjustments for non-cash charges such as stock-based compensation; depreciation and amortization; changes in accrued investment income; and fluctuations in operating asset and liability balances. Net cash used in operating activities was \$1.7 million for the quarter ended March 31, 2010, an increase in cash outflows of approximately \$2.6 million as compared to the same period in 2009. During the quarter ended March 31, 2010, net cash used in operating activities was primarily the result of our net loss of \$10.6 million, partially offset by changes in our operating assets and liabilities of \$4.1 million, stock-based compensation expenses of \$3.2 million, and depreciation and amortization expense of \$1.6 million. The primary components of the \$4.1 million decrease in our operating assets and liabilities were a \$7.9 million decrease in accounts receivable, a \$2.2 million increase in accrued liabilities, and an \$752,000 decrease in deferred cost of goods sold, the benefits of which were partially offset by a \$3.6 million increase in inventories, a \$1.9 million decrease in deferred revenues, and a \$1.3 million decrease in accounts payable. Accrued liabilities increased primarily as a result of a \$2.0 million increase in customer deposits. Accounts receivable decreased primarily as a result of reduced revenues during the first quarter of 2010 as compared to the fourth quarter of 2009. During the quarter ended March 31, 2010, total revenues were \$18.1 million compared to \$38.8 million during the quarter ended December 31, 2009. Deferred cost of goods sold decreased in conjunction with a decrease in deferred revenues. Inventories increased in preparation for an anticipated increase in shipments during the second quarter of 2010. Accounts payable decreased due to an overall reduction in the level of purchasing activity due to lower revenues in the first quarter of 2010 as compared to the fourth quarter of 2009, as well as the timing of expenditures during the first quarter of 2010.





**Table of Contents**

During the quarter ended March 31, 2009, net cash provided by operating activities was primarily the result of stock-based compensation expenses of \$3.0 million, depreciation and amortization expense of \$1.6 million, and changes in our operating assets and liabilities of \$6.8 million, partially offset by our net loss of \$10.6 million. The primary components of the \$6.8 million decrease in our operating assets and liabilities were a \$10.4 million decrease in accounts receivable and a \$1.7 million decrease in other current assets, the benefits of which were partially offset by a \$4.0 million increase in inventories and a \$1.0 million decrease in accounts payable. Accounts receivable decreased primarily as a result of reduced revenues during the first quarter of 2009 as compared to the fourth quarter of 2008. During the quarter ended March 31, 2009, total revenues were \$18.2 million compared to \$36.8 million during the quarter ended December 31, 2008. Other current assets decreased due to the receipt of \$1.9 million from one of our CEMs for non-trade receivable amounts due our company for materials they purchased from us. Inventories increased due in part to the sudden world-wide economic slowdown that occurred during the fourth quarter of 2008, as well as to our transition between CEMs which began in 2008 and continued through the first quarter of 2009. During this transition, we were required to purchase significant amounts of raw material inventory, much of which remained on our balance sheet as of March 31, 2009. Accounts payable decreased due to the timing of expenditures during the first quarter of 2009.

**Cash flows from investing activities.** Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash used in investing activities was \$5.5 million for the quarter ended March 31, 2010, a \$4.7 million decrease from the same period in 2009. During the quarter ended March 31, 2010, net cash used in investing activities was primarily the result of purchases of available-for-sale short-term investments of \$15.0 million and capital expenditures of \$464,000, partially offset by proceeds from maturities and sales of available-for-sale short-term investments of \$10.0 million. During the quarter ended March 31, 2009, net cash used in investing activities was primarily the result of purchases of available-for-sale short-term investments of \$28.9 million and capital expenditures of \$604,000, partially offset by proceeds from maturities and sales of available-for-sale short-term investments of \$19.4 million.

**Cash flows from financing activities.** Cash flows from financing activities have historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs and principal payments on our lease financing obligations. Net cash used in financing activities was \$918,000 for the quarter ended March 31, 2010, a \$1.3 million increase in cash outflows as compared to the same period in 2009. During the quarter ended March 31, 2010, net cash used in financing activities was primarily the result of \$633,000 worth of shares repurchased from employees for payment of employee taxes on vesting of performance shares and upon exercise of stock options and \$383,000 in principal payments on our building lease financing obligations, partially offset by proceeds of \$98,000 from the exercise of stock options by our employees. During the quarter ended March 31, 2009, net cash provided by financing activities was primarily the result of proceeds of \$763,000 from the exercise of stock options by our employees, partially offset by \$349,000 in principal payments on our building lease financing obligations and \$41,000 worth of shares repurchased from employees for payment of employee taxes on vesting of performance shares and upon exercise of stock options.

We use well-regarded investment managers to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated U.S. government securities, U.S. corporate obligations, and to a lesser extent, foreign corporate obligations and money market funds. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our Board of Directors.

We maintain a \$10.0 million line of credit with our primary bank, which expires on July 1, 2010. The letter of credit contains certain financial covenants requiring us not to exceed a certain maximum leverage ratio and to maintain a minimum level of liquid assets. As of March 31, 2010, we were in compliance with these covenants. As of March 31, 2010, our primary bank has issued, against the line of credit, two standby letters of credit totaling \$146,000. Other than issuing standby letters of credit, we have never drawn against the line of credit, nor have amounts ever been drawn against the standby letters of credit issued by the bank.

## **Table of Contents**

In the future, our cash reserves may be used to strategically acquire other companies, products, or technologies that are complementary to our business. In addition, our combined cash, cash equivalents, and short-term investments balances could be negatively affected by various risks and uncertainties, including, but not limited to, the risks detailed later in this discussion in the section title *Factors That May Affect Future Results of Operations*. For example, any continued weakening of economic conditions or changes in our planned cash outlay could negatively affect our existing cash reserves.

Based on our current business plan and revenue prospects, we believe that our existing cash reserves will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. However, we currently expect that our combined cash, cash equivalent, and short-term investment balance will decline during 2010. We expect that cash requirements for our payroll and other operating costs will continue at about existing levels. We also expect that we will continue to acquire capital assets such as computer systems and related software, office and manufacturing equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises. In the event that we require additional financing, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

### **RELATED PARTY TRANSACTIONS**

The law firm of Wilson Sonsini Goodrich & Rosati, P.C. acts as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, our Executive Chairman, M. Kenneth Oshman, uses his private plane or charter aircraft for Company business for himself and any employees that accompany him. In August 2008, our Board of Directors approved a reimbursement arrangement whereby our company will reimburse Mr. Oshman for 50% of the costs incurred for his private plane or charter aircraft travel used while on company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. During the quarter ended March 31, 2010, we recognized a total of approximately \$50,000 in expenses pursuant to the reimbursement arrangement, all of which has been included in general and administrative expenses in the Consolidated Statements of Operations. The Audit Committee of the Company's Board of Directors regularly reviews these reimbursements.

In November 2009, our Board of Directors approved a similar reimbursement arrangement for our President and Chief Executive Officer, Robert R. Maxfield, whereby our company will reimburse Mr. Maxfield for 50% of the costs incurred for charter aircraft used while on company business. During the quarter ended March 31, 2010, there were no expenses incurred pursuant to Mr. Maxfield's reimbursement arrangement.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for \$130.7 million. The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. A representative of Enel is not presently serving on our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LonWorks technology into Enel's remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2010, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

## **Table of Contents**

For the three months ended March 31, 2010 and 2009, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately \$362,000 and \$1.3 million, respectively. As of March 31, 2010, and December 31, 2009, \$5.8 million and \$6.1 million, respectively, of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

On October 29, 2001, we loaned Russell Harris, our Senior Vice President of Operations, \$1,000,000 in connection with his principal residence. Mr. Harris issued to us a promissory note secured by residential real estate. The note bore interest at the rate of 4.5% per annum, compounded monthly. The interest that accrued under the note was due and payable in monthly installments over the nine year term of the note, and the principal was due and payable on October 29, 2010. The principal was paid in full by Mr. Harris in June 2009. During the quarter ended March 31, 2009, interest paid by Mr. Harris was \$11,000. While it was outstanding, the terms of this loan were never amended.

### **RECENTLY ISSUED ACCOUNTING STANDARDS**

See the section entitled *Recent Accounting Pronouncements* in Note 1 of Notes to Condensed Consolidated Financial Statements in Item 1 of Part I of this Quarterly Report on Form 10-Q, which is incorporated herein by reference, for a full description of recent accounting pronouncements or changes in accounting pronouncements during the three months ended March 31, 2010, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the year ended December 31, 2009.

### **FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS**

*Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described in this section. This section should be read in conjunction with the condensed consolidated financial statements and accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q.*

#### **Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our business or operating results.**

Our business can be affected by a number of factors that are beyond our control, such as general geopolitical, economic, and business conditions. Recent turmoil in the worldwide financial markets, and the present economic slowdown and the uncertainty over its breadth, depth and duration continue to put pressure on the global economy and have a negative effect on our business. Further, the worldwide financial and credit crisis continues to limit the availability of liquidity and credit to fund the continuation and expansion of business operations worldwide. The shortage of liquidity and credit, combined with losses in worldwide equity markets, is contributing to the continuation of the world-wide economic recession.

While we do not currently depend on access to the credit markets to finance our operations, there can be no assurance that the deteriorated state of the financial markets will not impair our ability to obtain financing in the future, including, but not limited to, our ability to draw on funds under our existing credit facilities or our ability to incur indebtedness or sell equity if that became necessary or desirable. If we were not able to obtain additional financing when needed, our ability to invest in additional research and development resources and sales and marketing resources could be adversely affected, which could hinder our ability to sell competitive products into our markets on a timely basis.

In addition, there could be a number of follow-on effects from the credit crisis on our business, such as the insolvency of certain of our key customers, which could impair our distribution channels, or result in the inability of our customers to obtain credit to finance purchases of our products.

## **Table of Contents**

Also, the U.S. economic stimulus legislation enacted in 2009 has caused potential customers to delay their purchases until they determine if the economic incentives will become available to them under the legislation, and if so, the conditions under which the stimulus funds will be granted.

This uncertainty about future economic and political conditions makes it difficult for us to forecast operating results and to make decisions about future investments. We have already seen the effects of the economic slowdown on both our LWI and NES revenues. If economic activity in the U.S. and other countries' economies remains weak, many customers may continue to delay, reduce, or even eliminate their purchases of networking technology products. This could result in reductions in sales of our products, longer sales cycles, slower adoption of our technologies, increased price competition, and increased exposure to excess and obsolete inventory. For example, distributors could decide to further reduce inventories of our products. Also, the inability to obtain credit could cause a utility to postpone its decision to move forward with a large scale deployment of our NES System. If conditions in the global economy, U.S. economy or other key vertical or geographic markets we serve remain uncertain or continue to be weak, we would experience material negative impacts on our business, financial condition, results of operations, cash flow, capital resources, and liquidity.

### **Our NES revenues may not be predictable, which could cause volatility in the price of our stock.**

We and our partners sell our NES System to utilities. For several reasons, sales cycles with utility companies can be extended and unpredictable. Utilities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending. In addition, in many instances, a utility may require one or more field trials of an automated meter infrastructure (AMI) system (such as one based on our NES System) before moving to a volume deployment. There is also generally an extended development and integration effort required in order to incorporate a new technology into a utility's existing infrastructure. In addition, in the U.S., utilities have delayed deployments as they have sought incentives under the U.S. economic stimulus legislation. A number of other factors may also need to be addressed before the utility decides to engage in a full-scale deployment of our NES System, including:

- regulatory factors, standards compliance, or internal utility requirements that may affect the AMI system or the timing of its deployment;

- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;

- the deployment schedule for projects undertaken by our utility or systems integrator customers; and

- delays in installing, operating, and evaluating the results of an AMI field trial that is based on our NES System.

As a result, we can often spend up to two years working either directly or through a reseller to make a sale to a utility. At the end of that lengthy sales process, there is no guarantee that we will be selected by the utility.

In addition, shipment of NES products to a particular jurisdiction or customer is generally dependent on either obtaining regulatory approval for the NES meter or other products from a third party for the relevant jurisdiction, or satisfying the customer's internal testing requirements, or both. This certification approval process is often referred to as homologation. Further, shipment of NES products into some jurisdictions requires our contract manufacturers to pass certain tests and meet various standards related to the production of our NES meters. Failure to receive any such approval on a timely basis or at all, or failure to maintain any such approval, would have a material adverse impact on our ability to ship our NES System products, and would therefore have an adverse affect on our results of operations and our financial condition.

Once a utility decides to move forward with a large-scale deployment of an AMI project that is based on our NES System, the timing of and our ability to recognize revenue on our NES System product shipments will depend on several factors. These factors, some of which may not be under our control, include shipment schedules that may be delayed or subject to modification, other contractual provisions, such as customer acceptance of all or any part of the AMI system, and our ability to manufacture and deliver quality products according to expected schedules. In addition, the complex revenue recognition rules relating to products such as our NES System may also require us to defer some of our NES revenues until certain conditions, such as the acceptance of software deliverables, are met in a future period.



---

## **Table of Contents**

As a consequence of these long sales cycles, unpredictable delay factors, and complex revenue recognition policies, our ability to predict the amount of NES revenues that we may expect to recognize in any given fiscal quarter is likely to be limited. As NES revenues account for an increasing percentage of our overall revenues, we are likely to have increasing difficulty in projecting our overall financial results. Our inability to accurately forecast future revenues is likely to cause our stock price to be volatile.

### **Sales of our NES System may fail to meet our financial targets, which would harm our results of operations.**

We have invested and intend to continue to invest significant resources in the development and sales of our NES System. Our long-term financial goals include expectations for a reasonable return on these investments. However, to date the revenues generated from sales of our NES System products have not yielded gross margins in line with our long term goals for this product line, although our operating expenses have increased significantly.

In order to achieve our financial targets, we must meet the following objectives:

Increase market acceptance of our NES System products in order to increase NES revenues;

Increase gross margin from our NES revenues by continuing to reduce the cost of manufacturing our NES System products, while at the same time managing manufacturing cost pressures associated with commodity prices and foreign exchange fluctuations;

Manage the manufacturing transition to reduced-cost NES products; and

Manage our operating expenses to a reasonable percentage of revenues.

We cannot assure you that we will meet any or all of these objectives to the extent necessary to achieve our financial goals and, if we fail to achieve our goals, our results of operations are likely to be harmed.

### **Our executive officers and technical personnel are critical to our business.**

Our success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer and our technical personnel. In November 2009, we announced that our Chairman and CEO would step down as CEO for health reasons. At the same time, we announced that one of our existing directors would become our CEO on an interim basis, while we search for a new CEO. Our future success will depend on our ability to attract, integrate, motivate and retain a successor CEO and qualified technical, sales, operations, and managerial personnel.

Competition for qualified personnel in our business areas is intense, and we may not be able to continue to attract and retain a qualified CEO or other executive officers and key personnel. Our product development and marketing functions are largely based in Silicon Valley, which is a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are legally prohibited from making loans to executive officers, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find suitable replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

### **We are exposed to credit risk and payment delinquencies on our accounts receivable, and this risk has been heightened during the current decline in economic conditions.**

We only recognize revenue when we believe collectability is reasonably assured. However, almost none of our outstanding accounts receivables are covered by collateral or credit insurance. In addition, our standard terms and conditions permit payment within a specified number of days following shipment of product, or in some cases, after the customer's acceptance of our products. While we have procedures to monitor and limit exposure to credit risk on our receivables, there can be no assurance such procedures will effectively limit our credit risk and avoid losses. Additionally, when one of our resellers makes a sale to a utility, we face further credit risk, and we may defer revenue, due to the fact that the

## Edgar Filing: ECHELON CORP - Form 10-Q

reseller may not be able to pay us until it receives payment from the utility. This risk could become more magnified during a particular fiscal period if the resellers facing credit issues represent a significant portion of our accounts receivable during that period. As economic conditions change and worsen, certain of our direct or indirect customers may face liquidity concerns and may be unable to satisfy their payment obligations to us or our resellers on a timely basis or at all, which would have a material adverse effect on our financial condition and results of operations.

## **Table of Contents**

**Because we depend on a limited number of key suppliers and in certain cases, a sole supplier, the failure of any key supplier to produce timely and compliant products could result in a failure to ship products, which would harm our results of operations and financial position.**

Our future success will depend significantly on our ability to timely manufacture our products cost effectively, in sufficient volumes, and in accordance with quality standards. For most of our products requiring assembly, we rely on a limited number of contract electronic manufacturers (CEMs), principally Jabil and TYCO. These CEMs procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks, including reduced control over quality, costs, delivery schedules, availability of materials, components, finished products, and manufacturing yields. As a result of these and other risks, our CEMs could demand price increases for manufacturing our products. In addition, CEMs can experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

We also maintain manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in our NES System. The Neuron Chip is an important component that we and our customers use in control network devices. In addition to those sold by Echelon, the Neuron Chip is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Toshiba has informed us that it does not intend to renew its Neuron Chip agreement with us, which expired in January 2010. However, we have agreed with Toshiba that Toshiba will continue to accept orders for Neuron Chips from its customers through September 2011 for deliveries through December 2012. In the meantime, we are implementing a plan to allow for a smooth migration path for Toshiba's customers to our new Neuron 5000 processor, which we purchase from Open-Silicon. Another semiconductor supplier, STMicroelectronics, manufactures our power line smart transceiver products, for which we have no alternative source. In addition, we currently purchase several key products and components from sole or limited source suppliers with which we do not maintain signed agreements that would obligate them to supply to us on negotiated terms.

We are continuing to review the impact the ongoing worldwide financial crisis is having on our suppliers. Some of these suppliers are large, well capitalized companies, while others are smaller and more highly leveraged. In order to mitigate these risks, we may take actions such as increasing our inventory levels and/or adding additional sources of supply. Such actions may increase our costs and increase the risk of excess and obsolete inventories. Even if we undertake such actions, there can be no assurance that we will be able to prevent any disruption in the supply of goods and services we receive from these suppliers.

We may also elect to change any of these key suppliers. For example, in 2009 we completed the process of ending our relationship with a former CEM partner, Flextronics. As part of this transition, we moved the production of products Flextronics built for us to alternative CEMs. We were also required to purchase certain raw material and in-process inventory from Flextronics that Flextronics procured in anticipation of our production requirements. In addition, if any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time consuming to find a replacement. Also, as our NES business grows, we will be required to expand our business with our key suppliers or find additional sources of supply. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

moving raw material, in-process inventory, and capital equipment between locations, some of which may be in different parts of the world;

reestablishing acceptable manufacturing processes with a new work force; and



## **Table of Contents**

exposure to excess or obsolete inventory held by contract manufacturers for use in our products.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could result in our failure to ship products, which would adversely affect our revenues and gross profit, and could result in claims against us by our customers, which could harm our results of operations and financial position.

**Because the markets for our products are highly competitive, we may lose sales to our competitors, which would harm our revenues and results of operations.**

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, rapid changes in customer or regulatory requirements, and localized market requirements. In each of our markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses.

The principal competitive factors that affect the markets for our products include the following:

our ability to anticipate changes in customer or regulatory requirements and to develop or improve our products to meet these requirements in a timely manner;

the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;

our product reputation, quality, performance, and conformance with established industry standards;

our ability to expand our product line to address our customers' requirements, such as adding additional electricity meter form factors;

our ability to meet a customer's required delivery schedules;

our customer service and support;

warranties, indemnities, and other contractual terms; and

customer relationships and market awareness.

Competitors for our NES System products include Aclara, Elster, Enel, GE, IBM, Iskraemeco, Itron, the Landis+Gyr group of companies, Siemens, and Silver Spring Networks, which directly or through IT integrators such as IBM or telecommunications companies such as Telenor, offer metering systems that compete with our NES System offering.

For our LWI products, our competitors include some of the largest companies in the electronics industry, operating either alone or together with trade associations and partners. Key company competitors include companies such as Siemens and Tridium in the building industry; Allen-Bradley (a subsidiary of Rockwell Automation), Groupe Schneider and Siemens in the industrial automation industry; Siemens in the transportation industry; and Zensys in the home control market. Key industry standard and trade group competitors include BACnet, DALI, and Konnex in the buildings industry; DeviceNet, HART, and Profibus in the industrial control market; DLMS in the utility industry; Echonet, ZigBee and the Z-Wave alliance in the home control market; and the Train Control Network (TCN) in the rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the ZigBee alliance includes over 300 member companies with promoter members such as Ember, Emerson, Freescale, Itron, Kroger, Landis+Gyr, Philips, Reliant Energy, Schneider Electric, STMicroelectronics, Tendril, and Texas Instruments.

## Edgar Filing: ECHELON CORP - Form 10-Q

Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings. In addition, the utility metering market is experiencing a trend towards consolidation. As a result, these competitors may be able to devote greater resources to the development, marketing, and sale of their products, and may be able to respond more quickly to changes in customer requirements or product technology. Some of our competitors may also be eligible for stimulus money, which could give them an additional financial advantage. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position would be harmed.

## **Table of Contents**

**Because our products use components or materials that may be subject to price fluctuations, shortages, or interruptions of supply, we may be unable to ship our products in a timely fashion, which would adversely affect our revenues, harm our reputation and negatively impact our results of operations.**

We may be vulnerable to price increases for products, components, or materials, such as copper and cobalt. We generally do not enter into forward contracts or other methods of hedging against supply risk of these raw materials. In addition, in the past we have occasionally experienced shortages or interruptions in supply for certain of these items, including products or components that have been or will be discontinued, which caused us to delay shipments beyond targeted or announced dates. To help address these issues, we may decide to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results.

If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure them from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

**Due to the financial and operational risks associated with our international operations, our revenues may decline due to risks unrelated to our ability to sell our products.**

We have operations located in eleven countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 64.0% of our total net revenues for the quarter ended March 31, 2010, and 77.4% of our total net revenues for the same period in 2009. We expect that international sales will continue to constitute a significant portion of our total net revenues.

Changes in the value of currencies in which we conduct our business relative to the U.S. dollar have caused and could continue to cause fluctuations in our reported financial results. The three primary areas where we are exposed to foreign currency fluctuations are revenues, cost of goods sold, and operating expenses.

In general, we sell our products to foreign customers primarily in U.S. dollars. As such, fluctuations in exchange rates have had in the past and could continue to have an impact on revenues. As the value of the dollar rises, our products will become more expensive to our foreign customers, which could result in their decision to postpone or cancel a planned purchase.

With respect to the relatively minimal amount of our revenues generated in foreign currencies, our historical foreign currency exposure has been related primarily to the Japanese Yen and has not been material to our consolidated results of operations. However, in the future, we expect that some foreign utilities may require us to price our NES System in the utility's local currency, which will increase our exposure to foreign currency risk. In addition, we have agreed with EBV, our European distributor, that upon notice from EBV, we will sell our products to EBV in European Euros rather than U.S. dollars. If EBV were to exercise this right, our revenue exposure to foreign currency fluctuations would increase.

For our cost of goods sold, our products are generally assembled by CEMs in China. Although our transactions with these vendors have historically been denominated in U.S. dollars, in the future they may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases. In addition, any future increase in labor costs in the markets where our products are manufactured could also result in higher costs to procure our products.

We use the local currency to pay for our operating expenses in the various countries where we have operations. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

## **Table of Contents**

To date, we have not hedged any of our foreign currency exposures and currently do not maintain any hedges to mitigate our foreign currency risks. Consequently, any resulting adverse foreign currency fluctuations could significantly harm our revenues, cost of goods sold, or operating expenses.

Additional risks inherent in our international business activities include the following:

the imposition of tariffs or other trade barriers on the importation of our products;

timing of and costs associated with localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;

inherent challenges in managing international operations;

the burdens of complying with a wide variety of foreign laws; the applicability of foreign laws that could affect our business or revenues, such as laws that purport to require that we return payments that we received from insolvent customers in certain circumstances; and unexpected changes in regulatory requirements, tariffs, and other trade barriers;

economic and political conditions in the countries where we do business;

differing vacation and holiday patterns in other countries, particularly in Europe;

labor actions generally affecting individual countries, regions, or any of our customers, which could result in reduced demand for, or could delay delivery or acceptance of, our products;

international terrorism; and

potentially adverse tax consequences, including restrictions on repatriation of earnings.

Any of these factors could have a material adverse effect on our revenues, results of operations, and our financial condition.

### **Voluntary standards and governmental regulatory actions in our markets could limit our ability to sell our products.**

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. We participate in many voluntary standards organizations around the world in order to both help prevent the adoption of exclusionary standards and to promote voluntary standards for our products. However, we do not have the resources to participate in all voluntary standards processes that may affect our markets and our efforts to influence the direction of those standards bodies in which we do participate may not be successful. Many of our competitors have significantly more resources focused on standards activities and may influence those standards in a way that would be disadvantageous to our products.

Many of our products and the industries in which they are used are subject to U.S. and foreign regulation. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

## Edgar Filing: ECHELON CORP - Form 10-Q

In addition, the market for our NES and LWI products may experience a movement towards standards based protocols driven by governmental action, such as those being considered in the U.S. by NIST and in Europe by those related to the EU 441 mandate. To the extent that we do not adopt such protocols or do not succeed in achieving adoption of our own protocols as standards or de facto standards, sales of our NES and LWI products may be adversely affected.

## **Table of Contents**

The adoption of voluntary standards or the passage of governmental regulations that are incompatible with our products or technology could limit the market opportunity for our products, which could harm our revenues, results of operations, and financial condition.

### **We may be unable to promote and expand acceptance of our open, interoperable control systems over competing protocols, standards, or technologies.**

LONWORKS technology is open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our LWI customers are able to develop hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers in particular could develop competing products based on our open technology. For instance, we have published all of the network management commands required to develop software that competes with our LNS software.

In addition, many of our LWI competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. We also face strong competition from large trade associations that promote alternative technologies and standards for particular vertical applications or for use in specific countries. These include BACnet, DALI, and KNX in the buildings market; DeviceNet, HART, and ProfiBus in the industrial controls market; TCN in the rail transportation market; DLMS in the electric metering market; and Echonet, ZigBee, and Z-Wave in the home control market.

Our technologies, protocols, or standards may not be successful or we may not be able to compete with new or enhanced products or standards introduced by our LWI product line competitors, which would have a material adverse affect on our revenues, results of operations, and financial condition.

### **Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses.**

Our products may contain or may be alleged to contain undetected errors or failures. In addition, our customers or their installation partners may improperly install or implement our products, which could delay completion of a deployment or hinder our ability to win a subsequent award. Furthermore, because of the low cost and interoperable nature of our products, LONWORKS technology could be used in a manner for which it was not intended.

Even if we determine that an alleged error or failure in our products does not exist, we may incur expense and shipments and revenue may be delayed while we analyze the alleged error or failure. If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. This could delay our revenues and increase our expenses.

To address these issues, the agreements we maintain with our customers may contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. However, our customer contracts may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products.

Defects in our products may also cause us to be liable for losses in the event of property damage, harm or death to persons, claims against our directors or officers, and the like. Such liabilities could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

To help reduce our exposure to these types of liabilities, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. In addition, we believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. Significant cost increases could also result in increased premiums or reduced coverage limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims.

## **Table of Contents**

### **If we are not able to develop or enhance our products in a timely manner, our revenues will suffer.**

Due to the nature of development efforts in general, we often experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. In addition, such delays could impair our relationship with any of our customers that were relying on the timely delivery of our products in order to complete their own products or projects. We believe that similar new product introduction delays in the future could also increase our costs and delay our revenues.

### **If we do not maintain adequate distribution channels, our revenues will be harmed.**

We market our NES System products directly, as well as through selected VARs and integration partners. We believe that a significant portion of our NES System sales will be made through our VARs and integration partners, rather than directly by us. To date, our VARs and integration partners have greater experience in overseeing projects for utilities. As a result, if our relationships with our VARs and integration partners are not successful, or if we are not able to create similar distribution channels for our NES System products with other companies in other geographic areas, revenues from sales of our NES System products may not meet our financial targets, which will harm our operating results and financial condition.

Currently, significant portions of our LWI revenues are derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. Historically, sales to EBV, as well as sales to our other distributor partners, have accounted for a substantial portion of our total LWI revenues. Agreements with our distributor partners are generally renewed on an annual basis. If any of these agreements are not renewed, we would be required to locate another distributor or add our own distribution capability to meet the needs of our end-use customers. Any replacement distribution channel could prove less effective than our current arrangements. In addition, if any of our distributor partners fail to dedicate sufficient resources to market and sell our products, our revenues would suffer. Furthermore, if they significantly reduce their inventory levels for our products, service levels to our end-use customers could decrease.

### **Because we may incur penalties and/or be liable for damages with respect to sales of our NES System products, we could incur unanticipated liabilities that would negatively affect our operating results.**

In the event of late deliveries, late or improper installations or operations, failure to meet product specifications or other product failures, failure to achieve performance specifications, indemnities or other compliance issues, the agreements governing the sales of the NES System may expose us to penalties, damages and other liabilities. Even in the absence of such contractual provisions, we may agree, or may be required by law, to assume certain liabilities for the benefit of our customers. Any such liabilities would have an adverse effect on our financial condition and operating results.

### **If we sell our NES System products directly to a utility, we will face additional risks.**

When we sell our NES System products to a utility directly, we may be required to assume responsibility for installing the NES System in the utility's territory, integrating the NES System into the utility's operating and billing system, overseeing management of the combined system, working with other of the utility's contractors, and undertaking other activities. To date, we do not have any significant experience with providing these types of services. As a result, when we sell directly to a utility, it may be necessary for us to contract with third parties to satisfy these obligations. We cannot assure you that we would find appropriate third parties to provide these services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES System installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

### **The sales cycle for our LWI products is lengthy and unpredictable.**

The sales cycle between initial LWI customer contact and execution of a contract or license agreement with a customer or purchaser of our products, can vary widely. Initially, we must educate our customers about the potential applications of and cost savings associated with our products. If we are successful in this effort, OEMs typically conduct extensive and lengthy product evaluations before making a decision to design our products into their offerings. Once the OEM decides to incorporate our products, volume purchases of our products are generally delayed until the OEM's product development, system integration, and product introduction periods have been completed. In addition, changes in our customer's budgets, or the priority they assign to control network development, could also affect the sales cycle.

## **Table of Contents**

We generally have little or no control over these factors, any of which could prevent or substantially delay our ability to complete a transaction and could adversely affect the timing of our revenues and results of operations.

### **Fluctuations in our operating results may cause our stock price to decline.**

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet securities analysts expectations. Moreover, we have a history of losses and cannot assure you that we will achieve sustained profitability in the future. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

the mix of products and services that we sell may change to a less profitable mix;

shipment, payment schedules, and product acceptance may be delayed;

our products may not be purchased by utilities, OEMs, systems integrators, service providers and end-users at the levels we project;

we may be required to modify or add to our NES product offerings to meet a utility's requirements, which could delay delivery and/or acceptance of our products;

the complex revenue recognition rules relating to products such as our NES System could require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as delivery and acceptance criteria for our software and/or hardware products, are met in a future period;

our contract electronic manufacturers may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;

our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;

downturns in any customer's or potential customer's business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;

recording of expense relating to equity compensation will decrease our earnings;

we may incur costs associated with any future business acquisitions; and

any future impairment charges related to goodwill, other intangible assets, and other long-lived assets required under generally accepted accounting principles in the United States may negatively affect our earnings and financial condition.

Any of the above factors could, individually or in the aggregate, have a material adverse effect on our results of operations and our financial condition, which could cause our stock price to decline.

**Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others.**



## Edgar Filing: ECHELON CORP - Form 10-Q

We may be contractually obligated to indemnify our customers or other third parties that use our products in the event our products are alleged to infringe a third party's intellectual property rights. From time to time, we may also receive notice that a third party believes that our products may be infringing patents or other intellectual property rights of that third party. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management's attention and resources, and cause us to incur significant expenses. We do not insure against infringement of a third party's intellectual property rights.

## **Table of Contents**

As the result of such a claim, we may elect or be required to redesign our products, some of our product offerings could be delayed, or we could be required to cease distributing some of our products. In the alternative, we could seek a license to the third party's intellectual property. Even if our products do not infringe, we may elect to take a license or settle to avoid incurring litigation costs. However, it is possible that we would not be able to obtain such a license or settle on reasonable terms, or at all.

Lastly, our customers may not purchase our products if they are concerned our products may infringe third party intellectual property rights. This could reduce the market opportunity for the sale of our products and services.

Any of the foregoing risks could have a material adverse affect on our revenues, results of operations, and financial condition.

### **We have limited ability to protect our intellectual property rights.**

Our success depends significantly upon our intellectual property rights. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology.

We have also registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we fail to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary, or it may not be economically feasible to enforce them. Any of our patents, trademarks, copyrights or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States and it may take longer to receive a remedy from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights, or to prevent an unauthorized third party from misappropriating our products or technology.

### **The trading price of our stock has been volatile, and may fluctuate due to factors beyond our control.**

The trading price of our common stock is subject to significant fluctuations in response to numerous factors, including the following:

significant stockholders may sell some or all of their holdings of our stock;

---

**Table of Contents**

investors may be concerned about our ability to develop additional customers for our products and services; and

volatility in our stock price may be unrelated or disproportionate to our operating performance.

Any of these factors could have a negative impact on the market price of our stock.

**Our existing stockholders control a significant percentage of our stock, which will limit other stockholders' ability to influence corporate matters.**

As of April 30, 2010, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our board of directors), beneficially owned 29.1% of our outstanding stock.

When we sold 3.0 million newly issued shares of our common stock to Enel on September 11, 2000, we granted Enel the right to nominate a director to our board of directors, although a nominee of Enel does not currently sit on our board. In connection with the stock sale, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote in favor of Enel's nominee to our board of directors. In addition, Enel agreed to vote for our board's recommendations for the election of directors, approval of accountants, approval of Echelon's equity compensation plans, and certain other matters. As a result, our directors and executive officers, together with certain entities affiliated with them, may be able to control substantially all matters requiring approval by our stockholders, including the election of all directors and approval of certain other corporate matters.

**We are subject to numerous governmental regulations concerning the manufacturing and use of our products. We must stay in compliance with all such regulations and any future regulations. Any failure to comply with such regulations, and the unanticipated costs of complying with future regulations, may adversely affect our business, financial condition, and results of operations.**

We manufacture and sell products that contain electronic components that may contain materials that are subject to government regulation in the locations in which our products are manufactured and assembled, as well as the locations where we sell our products. Since we operate on a global basis, maintaining compliance with regulations concerning the materials used in our products is a complex process that requires continual monitoring of regulations and ongoing compliance procedures. While we do not currently know of any proposed regulations regarding components in our products that would have a material impact on our business, the adoption of any unanticipated new regulations that significantly impact the various components we use or require that we use more expensive components would have a material adverse impact on our business, financial condition and results of operations.

Our manufacturing processes, including the processes used by our suppliers, are also subject to numerous governmental regulations that cover both the use of various materials as well as environmental concerns. Since we and our suppliers operate on a global basis, maintaining compliance with regulations concerning our production processes is also a complex process that requires continual monitoring of regulations and ongoing compliance procedures. For example, environmental issues such as pollution and climate change have seen significant legislative and regulatory interest on a global basis. Changes in these areas could directly increase the cost of energy, which may have an impact on the way we or our suppliers manufacture products or use energy to produce our products. In addition, any new regulations or laws in the environmental area might increase the cost of raw materials we use in our products. We are currently unable to predict how any such changes will impact us and if any such impact could be material to our business. Any new law or regulation that significantly increases our costs of manufacturing or causes us or our suppliers to significantly alter the way that our products are manufactured would have a material adverse effect on our business, financial condition and results of operations.

**Natural disasters, power outages, and other factors outside of our control such as widespread pandemics could disrupt our business.**

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. A natural disaster, power outage, or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, and limiting our ability to sell our products. We do not insure against several natural disasters, including earthquakes.

## **Table of Contents**

Any outbreak of a widespread communicable disease pandemic, such as the outbreak of the H1N1 influenza virus in 2009 or the SARS epidemic of 2003, could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future health-related disruptions at our third-party contract manufacturers or other key suppliers could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

We have not experienced any material change in our exposure to interest rate and foreign currency risks since the date of our Annual Report on Form 10-K for the year ended December 31, 2009.

**Market Risk Disclosures.** The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

**Interest Rate Sensitivity.** We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 10% from levels at March 31, 2010 and December 31, 2009, the fair value of the portfolio would decline by an immaterial amount. We currently intend to hold our fixed income investments until maturity, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. However, if necessary, we may sell short-term investments prior to maturity to meet the liquidity needs of the company.

**Foreign Currency Exchange Risk.** We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. If foreign exchange rates were to fluctuate by 10% from rates at March 31, 2010, and December 31, 2009, our financial position and results of operations would not be materially affected. However, we could experience a material impact in the future.

In addition, for our cost of goods sold, our products are generally assembled by CEMs in China, although our transactions with these vendors have historically been denominated in U.S. dollars. These vendors may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### ***Evaluation of Effectiveness of Disclosure Controls and Procedures***

We have designed our disclosure controls and procedures to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. As of the end of the period covered by this Quarterly Report on Form 10-Q, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of March 31, 2010.

**Table of Contents**

***Changes in Internal Control Over Financial Reporting***

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended March 31, 2010, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

For a discussion regarding our legal proceedings and matters, please refer to the Legal Actions section of Note 6, Commitments and Contingencies, to our condensed consolidated financial statements included under Item 1 of Part I, Financial Information, which information is incorporated herein by reference.

**ITEM 1A. RISK FACTORS**

A restated description of the risk factors associated with our business is included under Factors That May Affect Future Results of Operations in Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 2 of Part I of this report. This description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Item 1A of our 2009 Annual Report on Form 10-K and is incorporated herein by reference.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In April 2008, our board of directors approved a new stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases under the new stock repurchase program during the quarter ended March 31, 2010. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of \$8.9 million. As of March 31, 2010, 2,250,000 shares were available for repurchase. The new stock repurchase program will expire in April 2011.

The following table provides information about the repurchase of our common stock during the quarter ended March 31, 2010:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
January 1-January 31	38,968	\$ 11.73		2,250,000
February 1-February 28	6,846	\$ 8.18		2,250,000
March 1-March 31	64,731	\$ 8.25		2,250,000
Total	110,545	\$ 9.47		2,250,000

- (1) Shares purchased that were not part of our publicly announced repurchase program represent those shares surrendered to us by employees in order to satisfy stock-for-stock option exercises and/or withholding tax obligations related to stock-based compensation. These purchases do not reduce the number of shares that may yet be purchased under our publicly announced repurchase program.

**Table of Contents**

**ITEM 6. EXHIBITS**

**Exhibit**

<b>No.</b>	<b>Description of Document</b>
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**ECHELON CORPORATION**

Date: May 6, 2010

By: **/s/ OLIVER R. STANFIELD**  
**Oliver R. Stanfield,**

**Executive Vice President and Chief Financial Officer**

**(Duly Authorized Officer and Principal Financial and Accounting Officer)**

**Table of Contents**

**EXHIBIT INDEX**

**Exhibit**

<b>No.</b>	<b>Description of Document</b>
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.